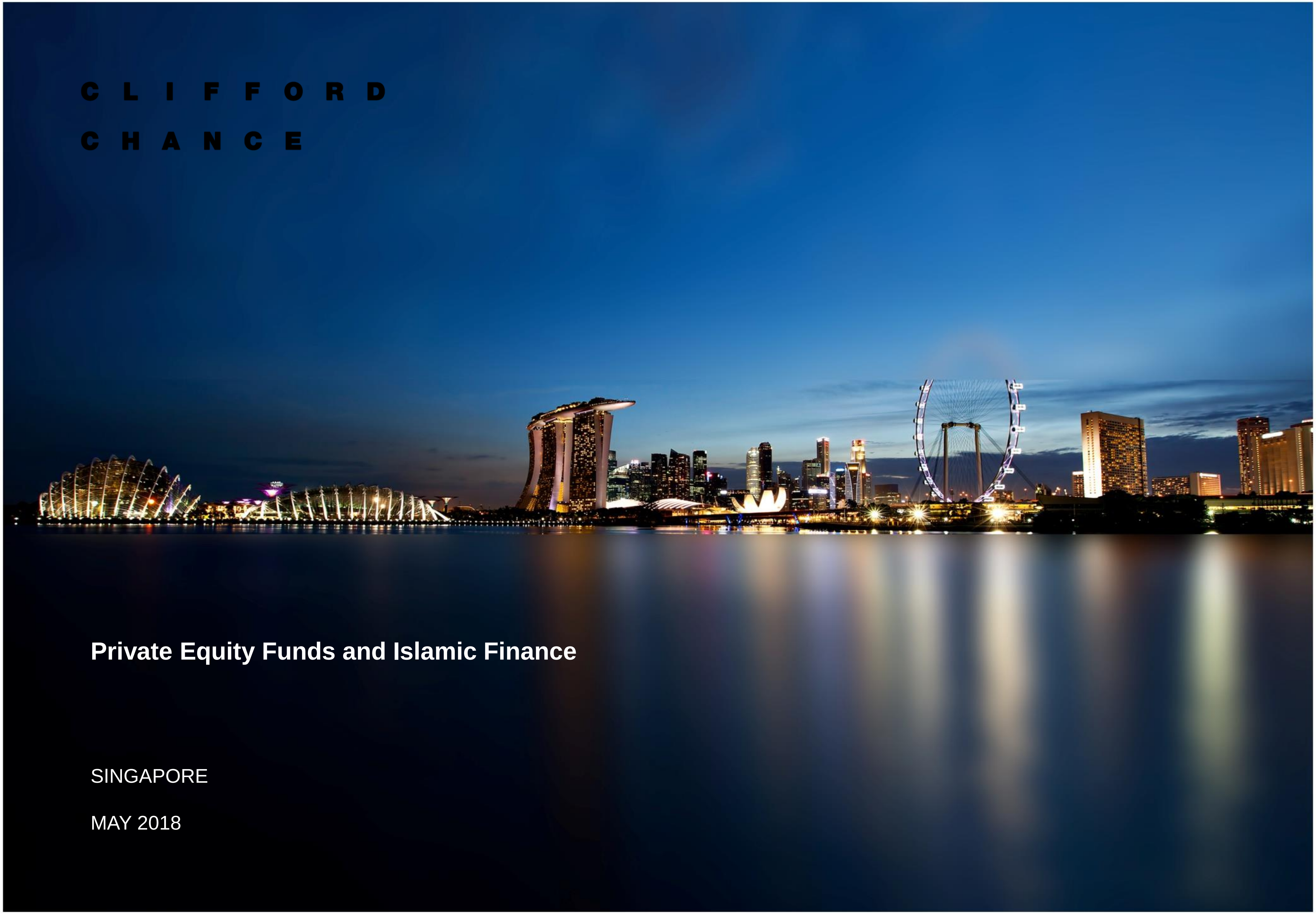


CLIFFORD CHANCE

Private Equity Funds and Islamic Finance

SINGAPORE

MAY 2018

Agenda

A. Private Equity Funds

1. Introduction
2. Typical Structures
3. Key Terms
4. Trends

B. Islamic Finance

1. Overview
2. Structures
3. Codification
4. Funds

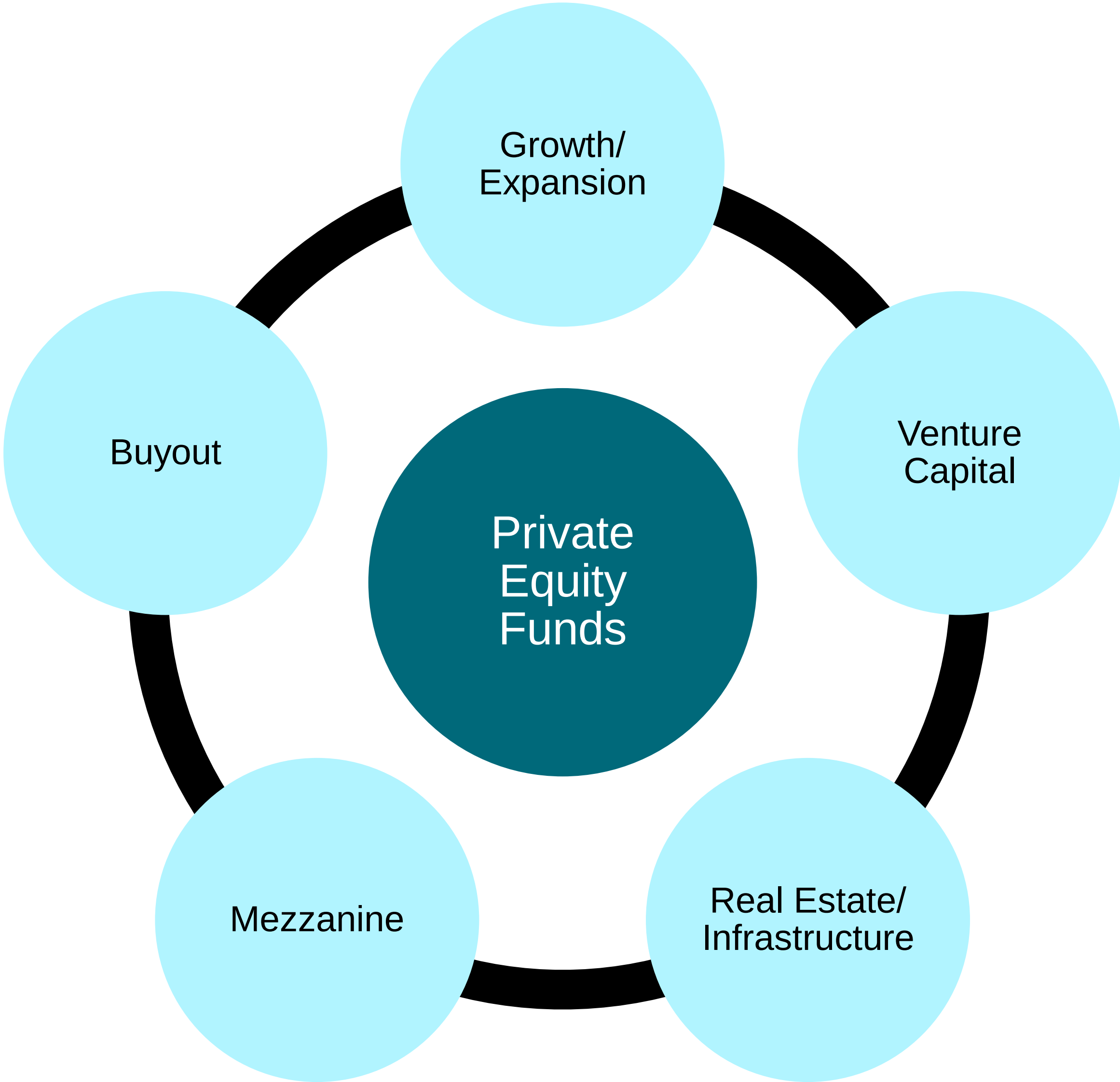
1. INTRODUCTION

What is a PE fund?

A private equity fund is a:

- collective investment vehicle
- pools capital from investors
- makes private investments within a defined investment policy
- generates a return

Types of private equity funds



Types of investors

Individual Investors

- high net worth investors

Institutional Investors

- banks
- insurance companies
- public and private pension plans
- funds of funds
- SWFs

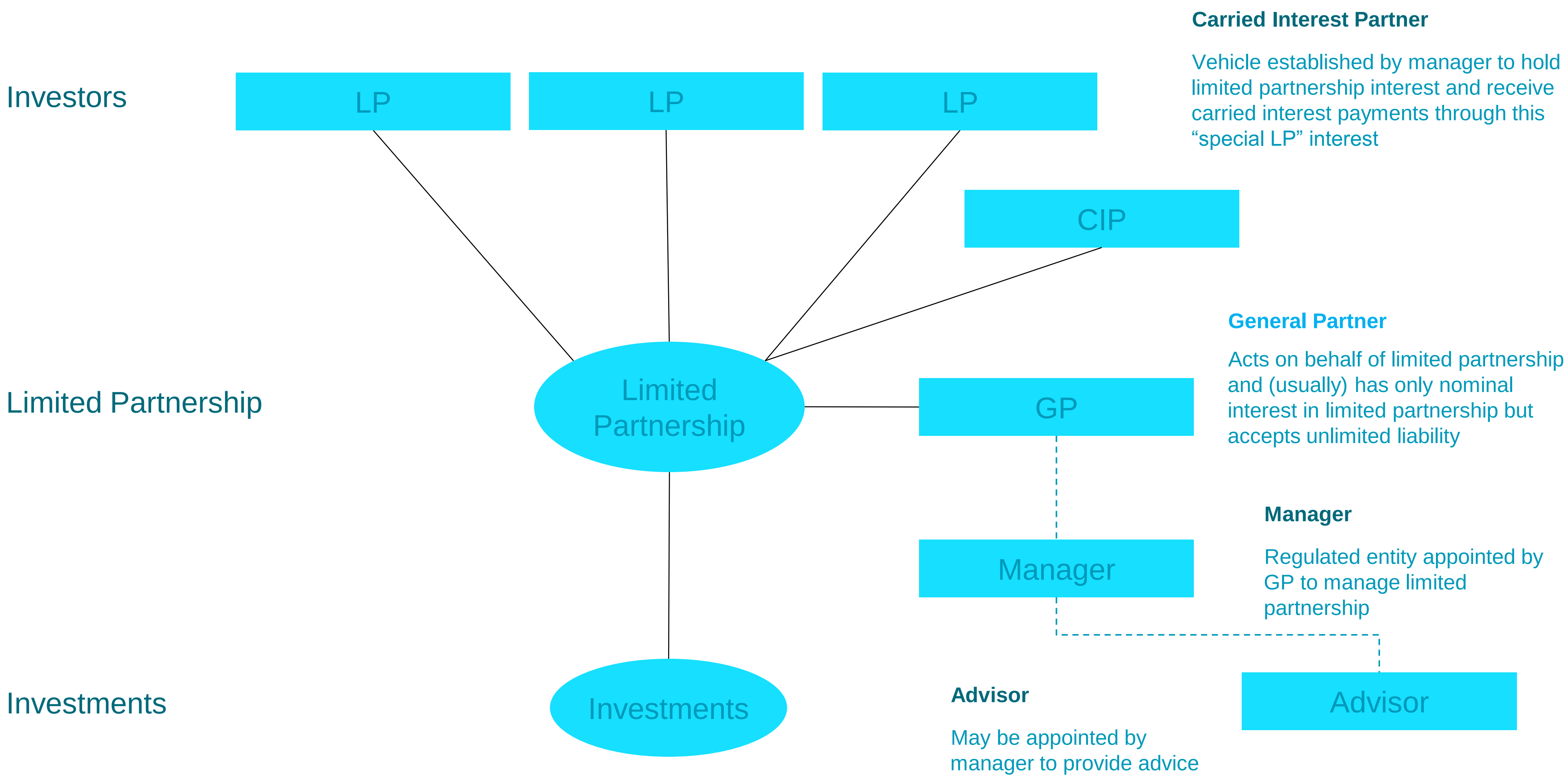
2. TYPICAL STRUCTURES

Domiciles

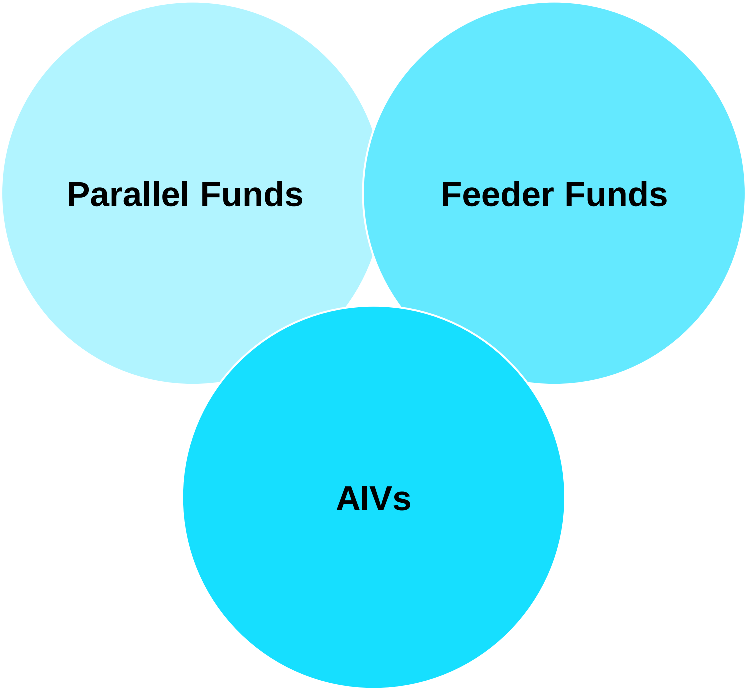
Types of investors and their regulatory and tax status dictate:

- type of vehicle
- jurisdiction of vehicle

Basic structure



Parallel funds, feeder funds and AIVs



Parallel funds

- may be necessary to facilitate investment by certain investors with special regulatory or tax requirements (e.g., US tax-exempt investors, ERISA investors, German investors, Australian superannuation funds, etc.)
- invest alongside fund in proportion to capital commitments and on substantially same terms and conditions
- share proportionately in expenses and voting rights aggregated
- separate parallel fund often used for marketing with EU passport

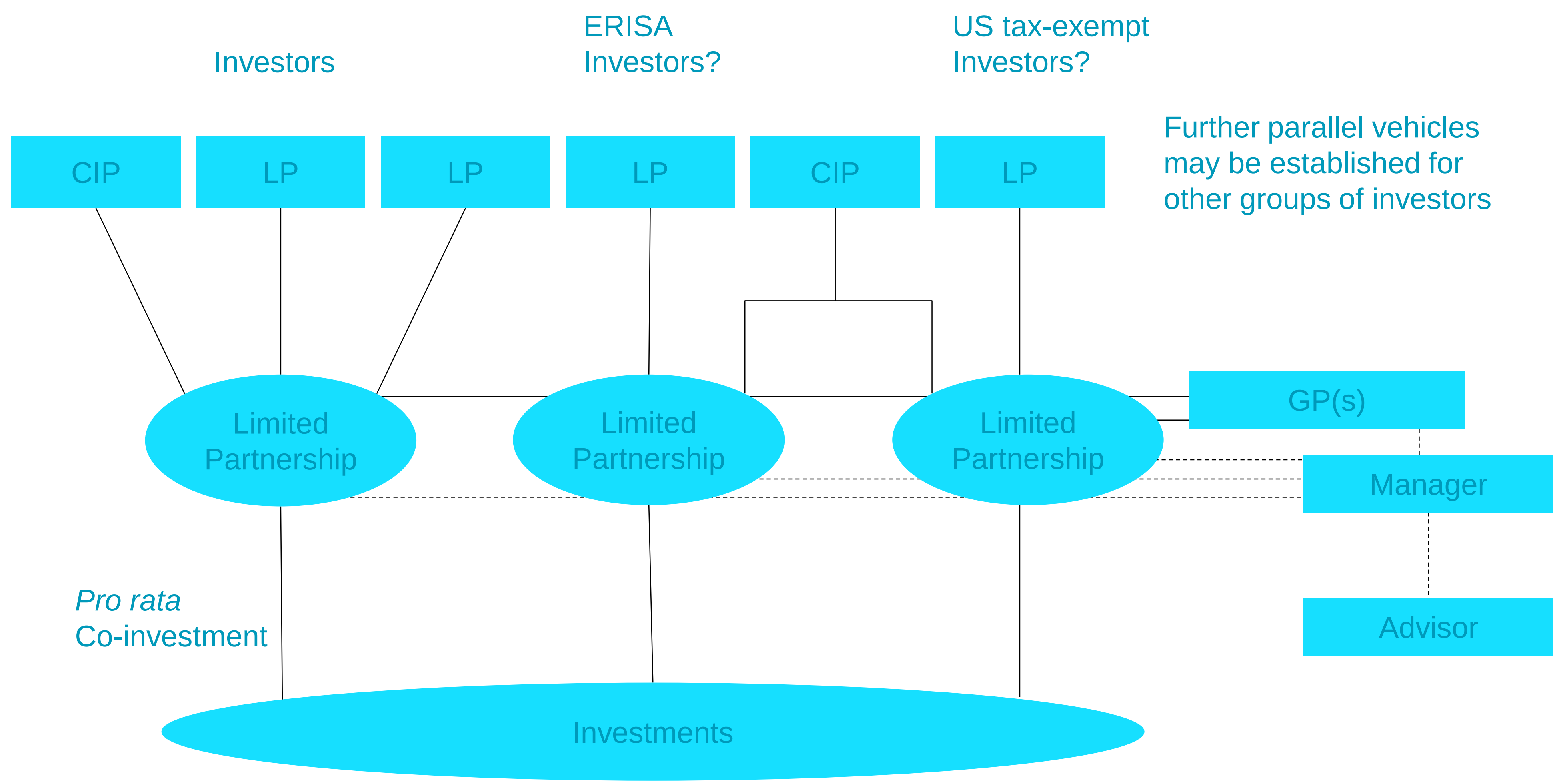
Feeder funds

- may be required by GP/investors
- investors invest in fund through feeder vehicle

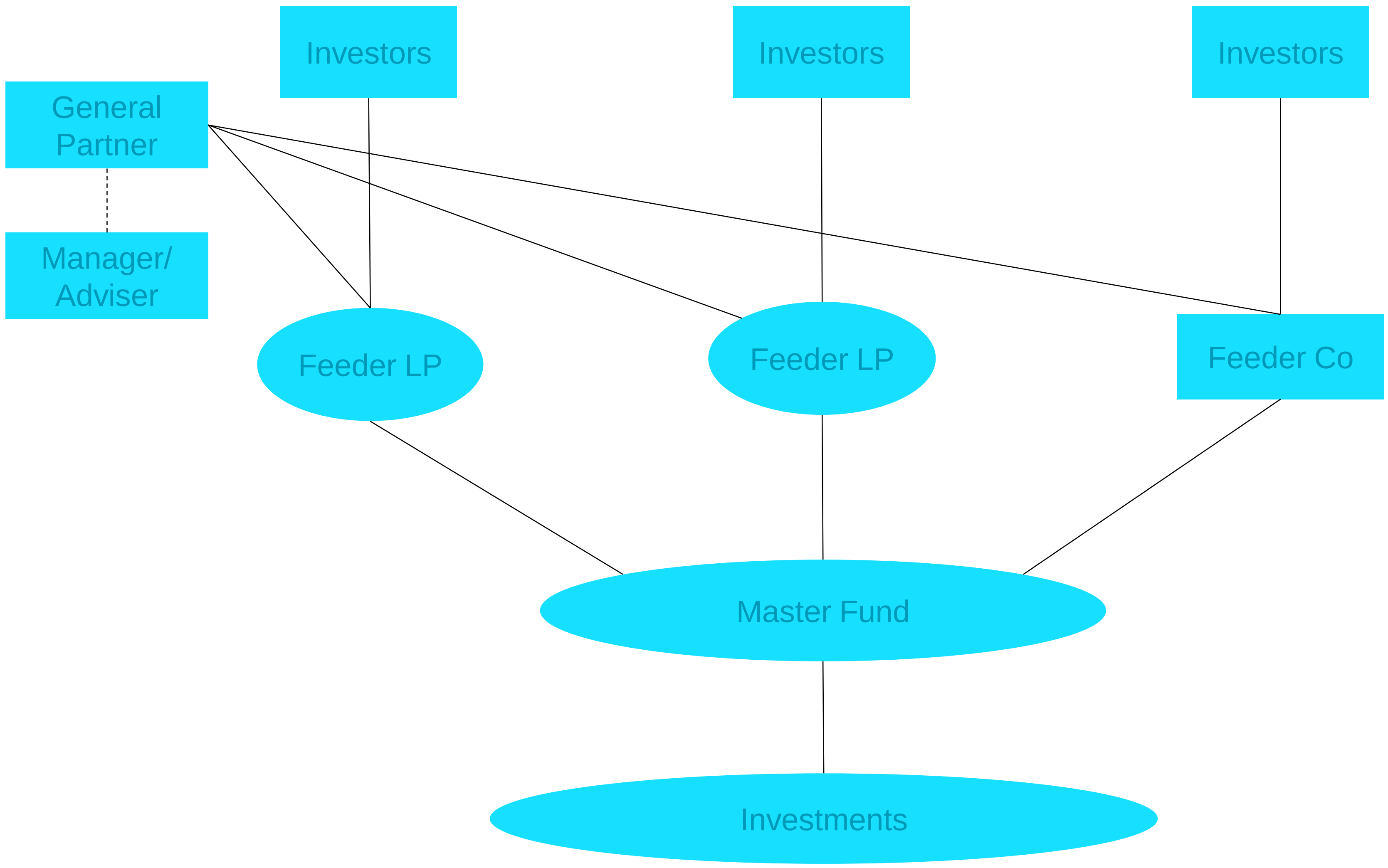
AIVs

- may be established by GP, if appropriate for legal, tax, regulatory or other reasons
- investors may be required to participate (only for one investment)
- alternative structure to fund (but investment-specific)
- management and economic terms and conditions substantially similar to those of fund

Example parallel funds



Example feeder funds



3. KEY TERMS

Investment policy and restrictions

Investment policy

- clear and definite investment objective to be memorialised
- restrictions based on benchmark/commitments

Typical investment restrictions

- acquisition cost as % of total commitments
- geographic
- sector
- single portfolio company
- leverage

Specific restrictions

- debt instruments
- publicly traded securities
- real estate
- other funds
- investment pace limitations

Commitments

GP commitment

- focus on higher GP commitment; 3-5% of total commitments now common
- downside protection matters even more important than upside incentivisation (i.e., carry interest)
- detailed schedules showing exactly who is committing what; house commitment perceived as less important than commitment of key persons

Source

- ability to offset management fee income against capital contributions versus pure cash commitment
- focus on leverage; investors' views vary, but generally views are influenced by level of recourse

Drawdowns

Purpose

- investments, management fees and costs and expenses

Investment period

- after end of investment period, drawdowns for investments limited to follow-ons and transactions in progress

Timing

- usually 10 business days

Effect

- preferred return accrues on drawdowns

Default

- severe consequences

Bridge facilities

- reduce frequency of drawdowns
- trend in PE towards 6-12 month bridges
- facilitate cash management / equalisation
- delays preferred return

Equalisation

Principle

- all LPs treated as if they were admitted at first closing
- can be a mechanism for additional LPs or increasing commitments of existing LPs

Additional payments

- management fee and other drawdowns treated separately

Interest

- LIBOR + x % versus preferred return

Distributions

- equalised as well

Recycling and reinvestment

Recycling (up to 100% of commitment invested)

- amounts drawn downs for management fees
- amounts drawn down for costs and expenses
- amounts drawn down for investments but not used

Reinvestment – possible options:

- acquisition cost of short-term / bridging investments
- acquisition cost of all investments
- acquisition cost and profits from all investments
- X % of total commitments (e.g., 125%)

Term and investment period

Term

10 years plus two one year extensions often with LPAC or majority LP consent

Investment period

5 years

Distribution waterfall

Order of payments

- repay capital contributions to LPs
- 8% preferred return / hurdle to LPs
- catch-up to GP / CIP
- thereafter 80% to LPs and 20% to GP / CIP (i.e., carried interest)

Carried interest calculation

- "fund as a whole" (all contributions returned for all investments plus preferred return)
- "deal-by-deal" (contributions returned only for current investment plus preferred return)
- hybrid

Carried Interest Arrangements – Sample language

Sample wording (simplified):

"Net proceeds attributable to the disposal of Investments in Portfolio Companies, together with any dividends or other income earned on such Investments, will be distributed in the following order of priority:

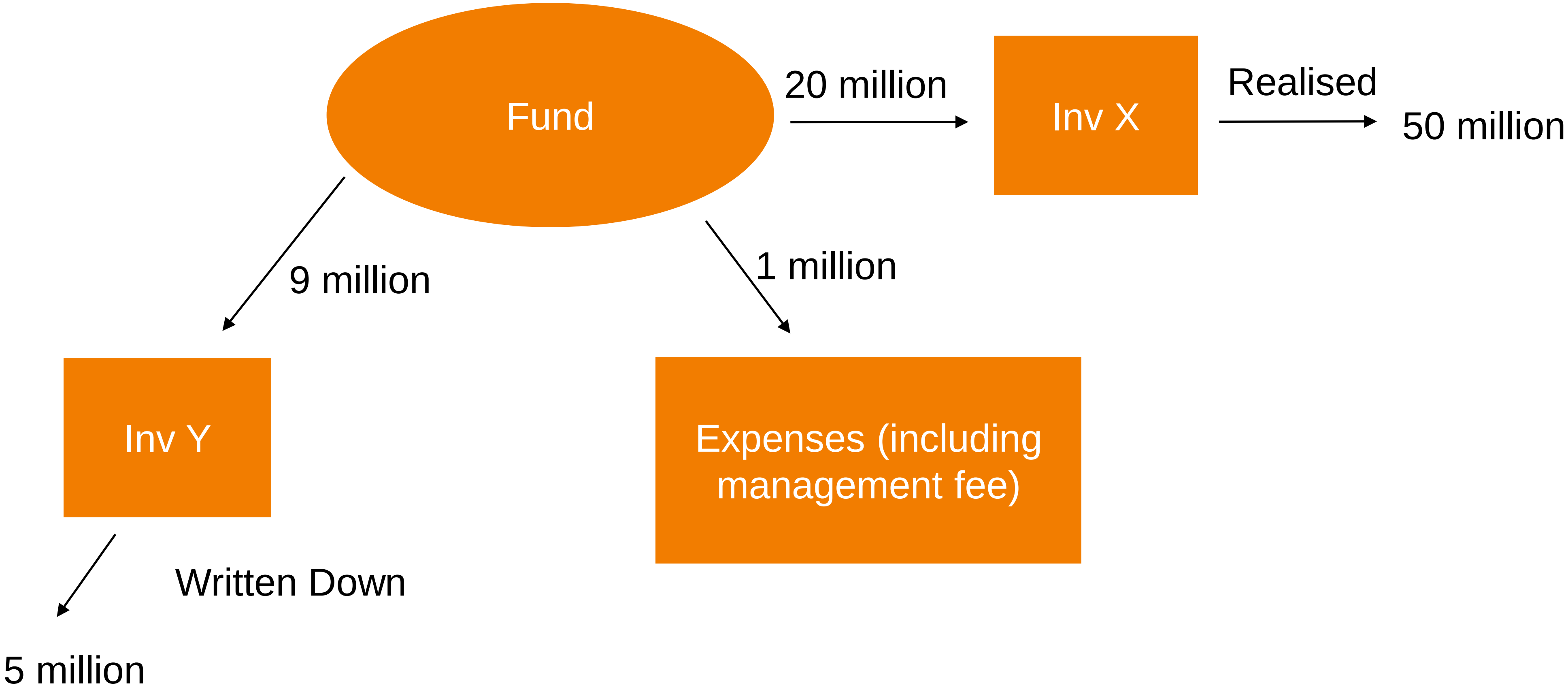
(1) **First**, to the Limited Partners in proportion to their respective drawn down Commitments, until an amount equal to the amount drawn down has been distributed;

(2) **Second**, to the Limited Partners in proportion to their respective drawn down Commitments, until an amount equal to 8% per annum compounded annually has been distributed;

(3) **Third**, 100% to the General Partner until the General Partner has received a sum equal to 20% of the total distributions made under paragraph (2) above and this paragraph (3); and

(4) **Fourth**, 80% to the Limited Partners in proportion to their respective drawn down Commitments and 20% to the General Partner (together with the amounts distributed to the General Partner under paragraph (3) above, referred to as the "Carried Interest")."

Carried Interest Arrangements



Carried Interest Arrangements (continued)

On a realisation of Inv. X after 12 months:

First Drawn down commitments

20 + 9 + 1 =
30 million → Limited Partners

Second Hurdle Rate

8% of 30 million
= 2.4 million → Limited Partners

Third Catch up

20% of hurdle rate plus
catch up = 0.6 million → General Partner

Carried Interest Arrangements (continued)

On a realisation of Inv. X after 12 months (continued):

Fourth Carried Interest

Undistributed profits
50 - (30 + 2.4 + 0.6)
= 17 million

80% of 17
= 13.6 million → Limited Partners

20% of 17
= 3.4 million → General Partner

Share of profits
Limited Partners — 2.4 + 13.6 = 16 million
General Partner — 0.6 + 3.4 = 4 million

GP Clawback

Carried interest clawback

- timing – at the end, at interim – predetermined periods or both?

Amount

- gross or net of taxes applicable to carry recipients

Actual tax liability of GP member

- may differ from highest hypothetical marginal tax rate in designated jurisdiction
- residence in more favourable tax jurisdiction

Escrow or guarantee?

LP Giveback

Scope

- indemnification claims
- warranty claims

Limits

- lesser of amounts equal to
  - distributions in previous 2 years; and
  - 25% of LP's commitment

Other points

- automatic trigger of GP clawback
- LP giveback often applies to all fund vehicles, including any co-investment vehicle of GP
- carve out for excused investments?

Management fee

Key trends

- step-down in base and rate post-investment period
- lower rates
- other trends include discounts for certain investors and provision of budgets

Discounts

- discounts for first closers still popular, but tricky in practice
- increasing pressure from subsequent closers to offer equivalents aggravates genuine first closers
- first closers beginning to seek express prohibition; size discounts also increasingly common (e.g., 5% off total management fees for commitments of more than US$100 million)

GP financials

- common to provide extensive financial information to justify fee rates
- investors now starting to focus on more detail (i.e., how remuneration works (prefer lower salaries with more to be paid as performance-linked bonuses)

Costs and expenses

Organisational expenses

- Paid by fund
- Caps
- Exclude placement fees (and sometimes placement expenses)

Operating expenses

- Paid by fund
- Treatment of additional services provided by manager versus outsourcing
- Drawing the line between fund and manager costs

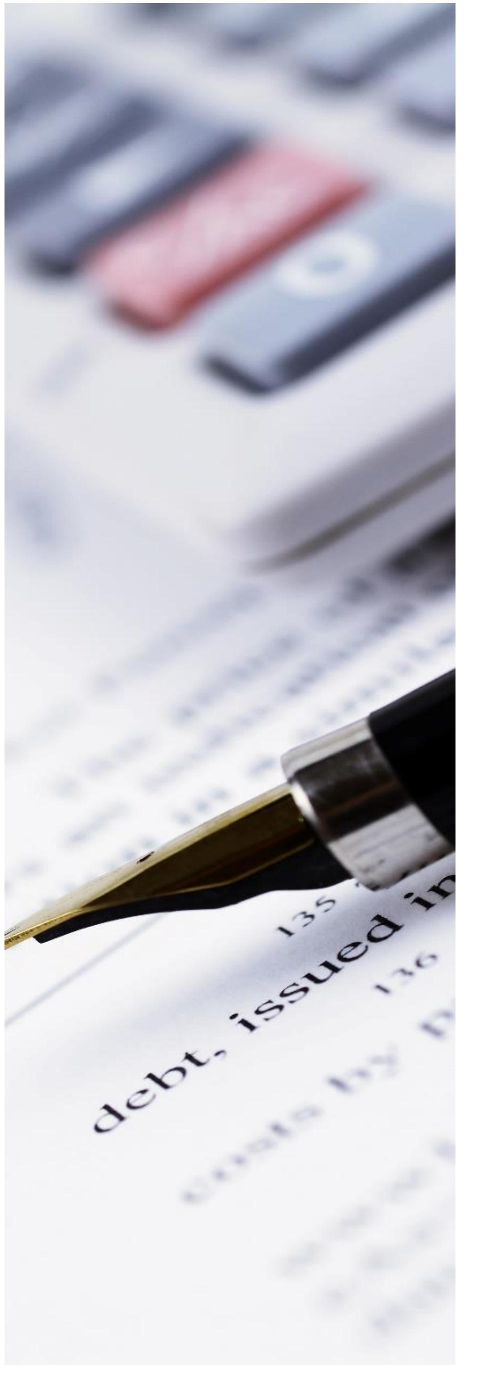
Limited partner / vehicle costs

- Borne by specific LP / entity
- Assistance and transfer costs most common examples

Manager expenses

- Paid by manager
- Costs of salaries, rent, etc.

Transaction and other fee income



Fees charged to investments by manager

- transaction fees, underwriting fees, abort fees, monitoring fees, investment related fees, directors' fees, syndication fees, etc.
- 100% offset against management fee now very common (sometimes after abort costs)

Should all fees be offset?

- some managers legitimately rely on further fees (especially smaller ones)

Co-investments and fees/expenses

SEC scrutiny on fee practices

Key persons

Rationale

- investors commit on basis of success of management team – for certainty, LPs will want certain key members to remain with the fund for at least duration of investment period

Triggers

- Key person event when a key person leaves the fund, ceases to have significant involvement in activities of fund/manager or breaches exclusivity / non-compete provisions

Consequences

- automatic suspension of investment period – as opposed to termination of fund – now the norm
- fees during suspension

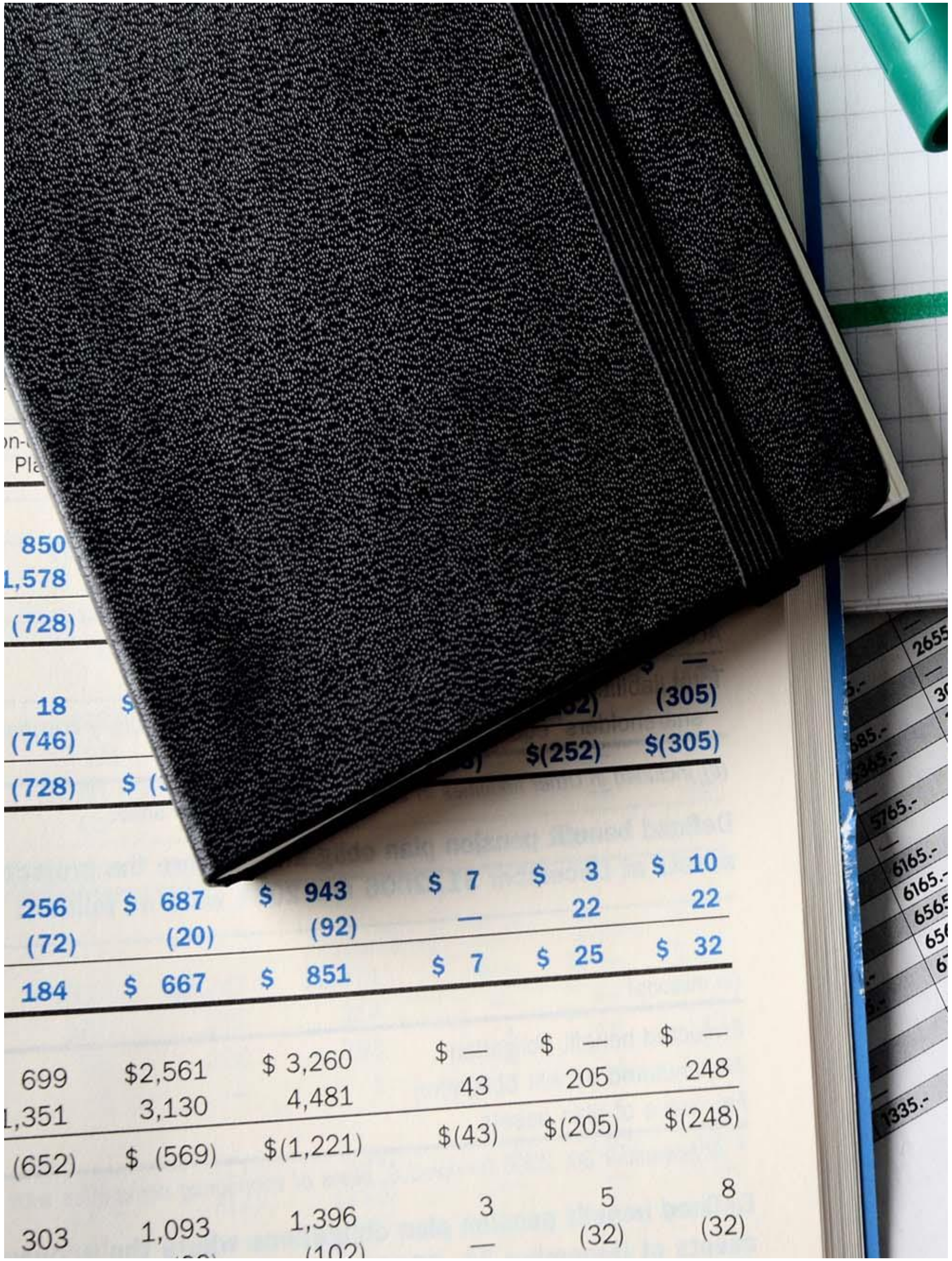
Co-investment

Facts

- investor appetite for co-investment has continued grow over the last several years
- co-investments now represents approx 10% of PE assets under management
- provides a number of benefits to both GPs and LPs

Regulation

- focus on fees and expenses / conflicts of interest



Termination and removal rights

Procedure

- for cause removal of GP or termination of fund upon vote of majority of LPs
- no fault suspension / termination of investment period / fund upon vote of supermajority of LPs
- no fault removal of GP upon vote of supermajority of LPs

Cause

- where the GP does something to warrant being removed: trigger events, court determination, cure period?
- LPs consider “for cause” removal all but impossible

No fault

- where LPs issue notice to remove on GP without there being an event to trigger such removal
- notice periods, compensation

Conflicts of interest

Potential conflicts

- successor funds
- transactions with affiliates
- allocations of deal flow
- co-investment rights

LP Advisory Committee (LPAC)

LPAC

Purpose

- mechanism to work through unforeseen conflicts as well as changes to investment team or other fund parameters

Role

- no broad governance role under limited partnership law, rather its formal responsibilities defined by LPA
- reviews and approves: (a) transactions that pose conflicts of interest, such as cross-fund investments and related party transactions, (b) methodology used for valuations (and in some cases, the valuations themselves), and (c) certain other consents or approvals pre-defined in LPA

Exculpation and indemnification

Definition

- exculpation — standard of care owed to LPs
- indemnification — contractual obligation to reimburse without mitigation of loss, out of fund assets, a person for actions by that person

Purpose

- protection of principals from personal liability or loss arising out of their activities in conducting fund business

Who is indemnified?

- GP, manager and their respective affiliates, members, officers, directors, employees and agents
- members of LPAC

Standards

- fraud, gross negligence, wilful misconduct and material breach of LPA resulting in adverse impact for the fund

Other negotiated items

- internal GP disputes
  - no right of indemnity for claims arising from dispute between indemnified persons
- liability after divestment
  - right of indemnity survives
  - LP giveback
- advancement of expenses (lawsuits brought by LPs)
  - repayment to fund if subsequently determined that there is no right of indemnity
- GP clawback interaction

Excuse rights

Key points

- internal policies
- manager discretion
- cancel commitment / use on other deals?

Mechanism for excuse

- simple notice, legal opinion
- time of notification: prior to subscription or immediately following receipt of drawdown notice
- excused LP may request to be excluded not only from any benefits from an investment but also any liabilities related to such investment (actual or contingent) (i.e., management fee, carried interest, LP clawback and indemnity)

Non-excused investors

- obligating non-excused investors to increase their percentage commitment to specific investment
- potentially long and time consuming pre-emption process

LPA amendments

Requirements

- generally investor consent rather than advisory committee consent
- notification to all investors
- no amendment that has a material adverse impact on any LP without such LP's consent (e.g., amendments to economic / voting rights)
- exception: correction of manifest / typographical error without adverse impact on rights of investors

Who is ILPA?

Global voluntary association of PE LPs

Purpose

- advancing interests of PE LPs

Membership

- initially founded as an informal networking group
- grown to include over 400 member organisations, representing US$1 trillion of private assets globally
- type of members: small and large institutions, including public pensions, corporate pensions, endowments, foundations, family offices and insurance companies
- international representation from North America, UK, Europe, Asia, Australia, South America, New Zealand and the Middle East
- funded by its members, meetings semi-annually

Activities

- information sharing through education programs and research
- networking opportunities and global collaborations through conferences and events
- publication of best practices

4. TRENDS

Where have GPs regained ground?

Waterfall

Classic whole-of-fund model still typical, but notable exceptions in Asia; creativity increasingly common

Management fees

Ticket size-related discounts still exist, but less frequent and smaller amounts

No fault divorce

Sometimes resisted altogether now; alternatively, often softer round the edges (e.g., require physical LP meeting; reintroduction of the honeymoon period; extended fee compensation)

Recycling

Powers drafted with increasing flexibility

Term extensions

Managers building in flexibility (e.g., secondary proposals) to cater for the "twilight years"

Control of fundraising process generally

Faster, more streamlined closings; fewer protracted bilateral negotiations (although note DFIs)

What are LPs focusing on?

Old favourites

Key Person

GP-friendly movement on suspension mechanisms, “free” replacements

Team commitment

Including timing and detailed breakdown of who commits what

Investment policy

Continued focus on strategy, irrespective of returns

Conflicts

Increasing pressure of consent rights instead of consultation

GP clawback protections

Escrow requests now common, but still possible to resist

Some new points

LPAC review

Of ongoing expenses, fees and co-investment allocations

Tax avoidance, reporting and BEPS

Tension between assurances on efficiency versus reputational concerns

Apportionment of expenses

More scrutiny of “expensive LPs” and allocation of expenses to co-investors

Compliance

Very granular, e.g., DDQ queries regarding number and compensation of compliance staff, relationship with regulators

Islamic Finance

Part 1
OVERVIEW

What is Islamic finance?

What is Islamic finance?

- As practised today, Islamic finance involves the application of *Shari'a* principles to financial activity
- Traditional techniques and structures, evolved and refined, within parameters of Islamic jurisprudence, to accommodate modern financial institutions and modern banking
- Applicable to range of financial products
- Ethical form of financing
- Often tries to achieve similar commercial outcomes to conventional financing

Common misconceptions

- It’s only relevant to Muslims
- Just replace the term “interest” with “profit/commission”
- More expensive than conventional finance

Basic principles

What is *Shari'a*?

- Qur'an
  - The sacred book that records the word of God as revealed to the Prophet Muhammed
- Hadith
  - The body of documents that records the Sunnah (the practice of "life-example") of the Prophet Muhammed
- Developments of *Shari'a*:
  - Fiqh – Islamic jurisprudence
  - Ijma – consensus
  - Qiyas – analogy
  - Ijtihad – interpretation

Shari'a compliance

- Every Muslim should live their life in accordance with *Shari'a* principles
- *Shari'a* gives guidance as to what is, and what is not, acceptable behaviour in all areas of a Muslim's life (including economic and commercial activity)
  - If something is permissible, it is referred to as being halal
  - If something is not permissible, it is referred to as being haram

The key prohibitions

What is not permissible (haram):

- Interest (riba)
  - Prohibits charging of interest and also prohibits usury or unjust enrichment
- Speculation (maisir)
  - Speculation or gambling (obtaining wealth without effort)
- Uncertainty (gharrar)
  - There must be full disclosure and certainty (e.g. certainty as to the subject matter or price of a contract)
- Unjust Enrichment
  - The financier should only generate benefit from the project in which it invests and must assume a degree of risk to obtain reward
- Unethical Investments
  - Islam is intolerant of certain products (e.g. alcohol, arms, pork) and activities (e.g. gambling)

Interest (riba)

- Best known and biggest practical difference from conventional finance
- Underlying concept: money has no intrinsic value, it is simply a means of facilitating trade
  - There should be no charge for the use of money
- Does not preclude obtaining a rate of return on an investment or profit from a commercial venture
- Islamic finance is sometimes said to be “asset based” as the trading of assets is often used to create obligations (where money is just the payment mechanism)

Speculation (maisir)

- Contracts which involve speculation are not permissible and are considered void
- Test is whether something has been gained by chance rather than by productive effort
  - What is the commercial substance of the contract?
  - General commercial speculation is not prohibited
  - Speculation akin to gambling is prohibited

Uncertainty (gharrar)

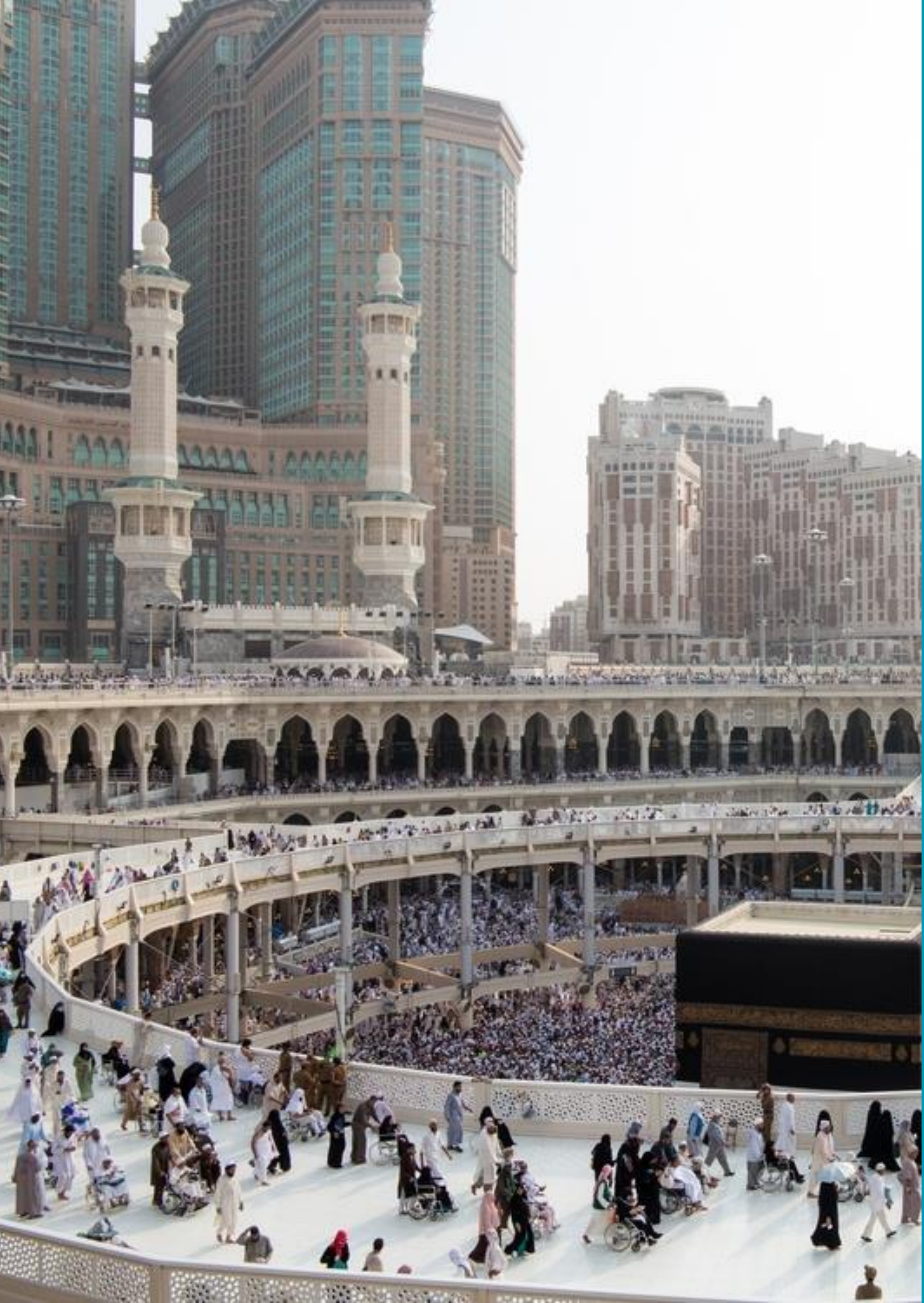
- Contracts which contain uncertainty will be considered void
  - *Shari'a* requires absolute certainty on all fundamental terms on its face
    - E.g. subject matter, price, time for delivery
  - Where uncertainty may arise out of the actual subject matter or substance of a contract, contract will be void
- Wider in scope than English common law principle of uncertainty

Unjust enrichment / unfair exploitation

- Contracts where one party is regarded as having gained unjustly at the expense of another will be considered void
- *Shari'a* principle is wider in scope than English common law principle
- *Shari'a* principle of unjust enrichment applies to
  - Enrichment of one party at the expense of another which cannot be justified
  - Enrichment of one party who exercises undue influence or duress over another

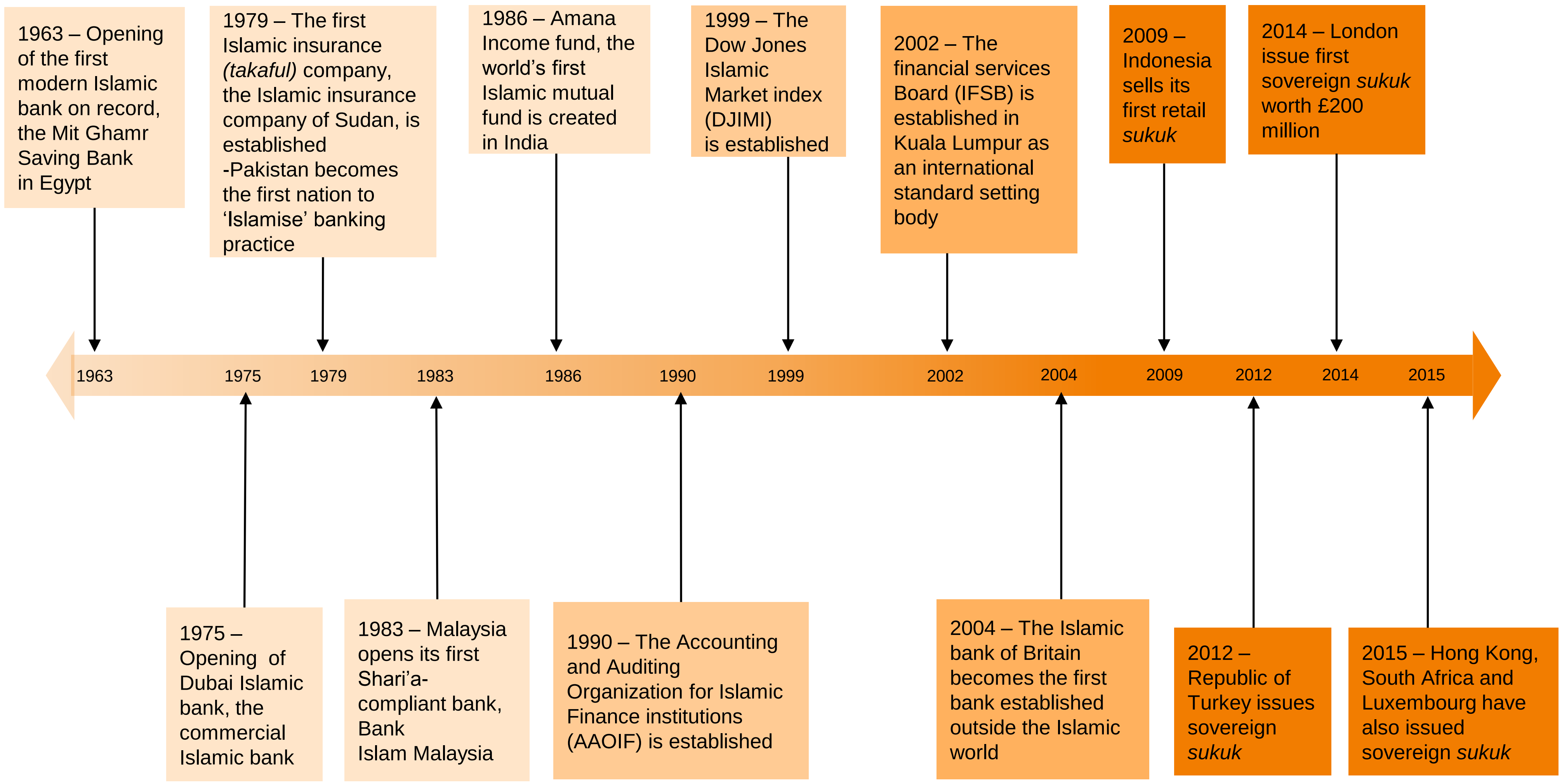
Shari'a board/committee

- Made up of Islamic scholars
- Scrutinise proposed transactions to ensure compliance with Islamic principles
- Supervisory
  - review structure papers and documentation
  - supervise implementation
- Opinions
  - informal
  - formal, by way of a fatwa
- Review overall financing methods and operations of Islamic financial institutions
- No uniform set of standards or interpretation

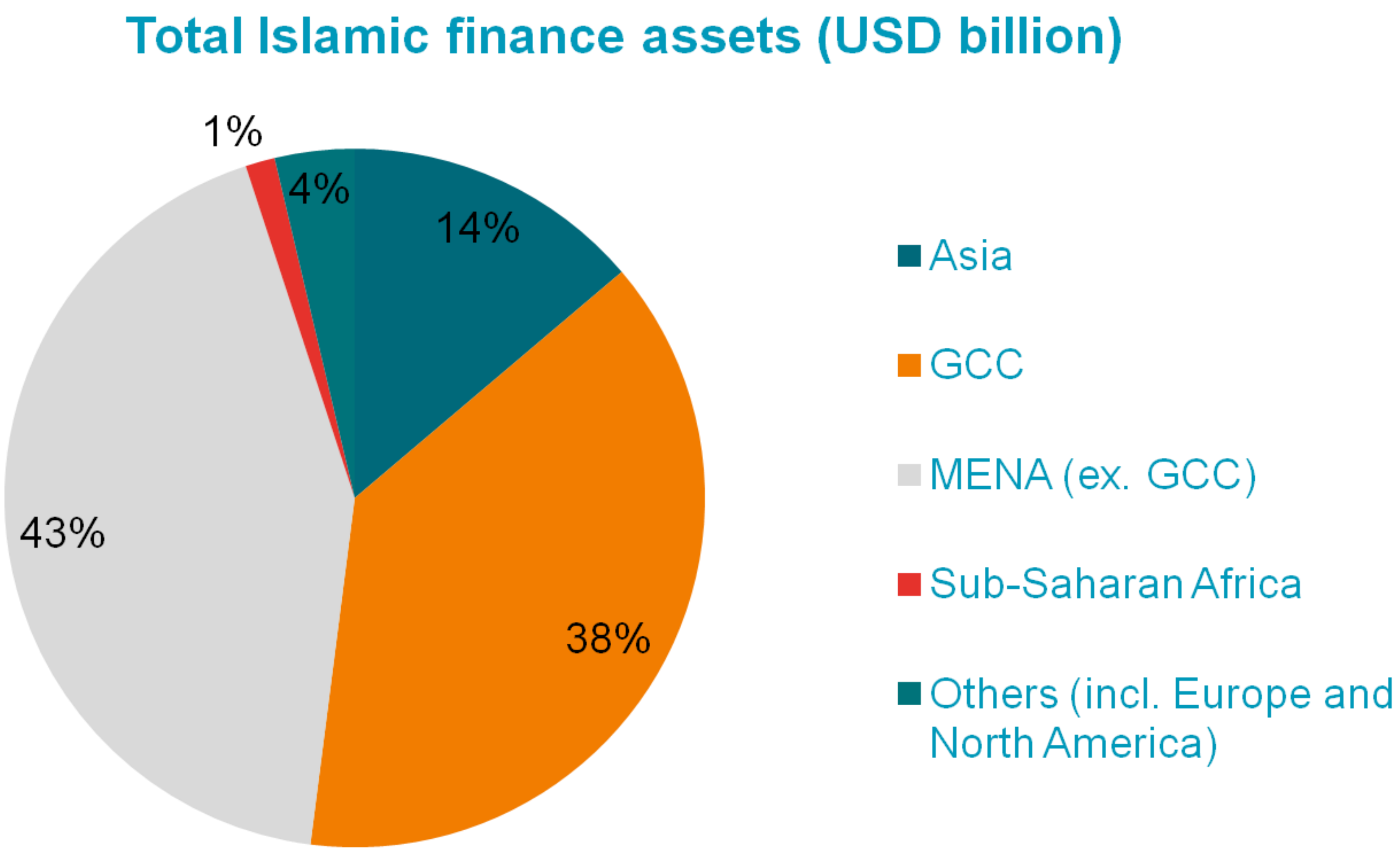


Islamic finance industry

Growth of Islamic finance industry



Islamic finance industry by region



Source: Islamic Financial Services Industry Stability Report 2015

Islamic finance in perspective

- Global Islamic financial services market now estimated to be US$1 trillion
- Fastest growing segment of the financial industry
  - Despite rapid growth, global Islamic finance market only represents around 1% of worldwide financial services industry
- By 2030, Muslims will make up more than a quarter of global population
- Popularity in non-Muslim jurisdictions
- Islamic finance is a credible alternative to conventional financing
  - Growing demand for ethical investment
- Regulations changing globally to accommodate

Part 2
STRUCTURES

Recognised structuring principles

Murabaha (cost-plus financing)

Tawarruq / Commodity Murabaha (murabaha financing)

Ijara (leasing)

Istisna'a (construction financing)

Wakala (agency)

Sukuk (Islamic bond)

Musharaka (equity financing)

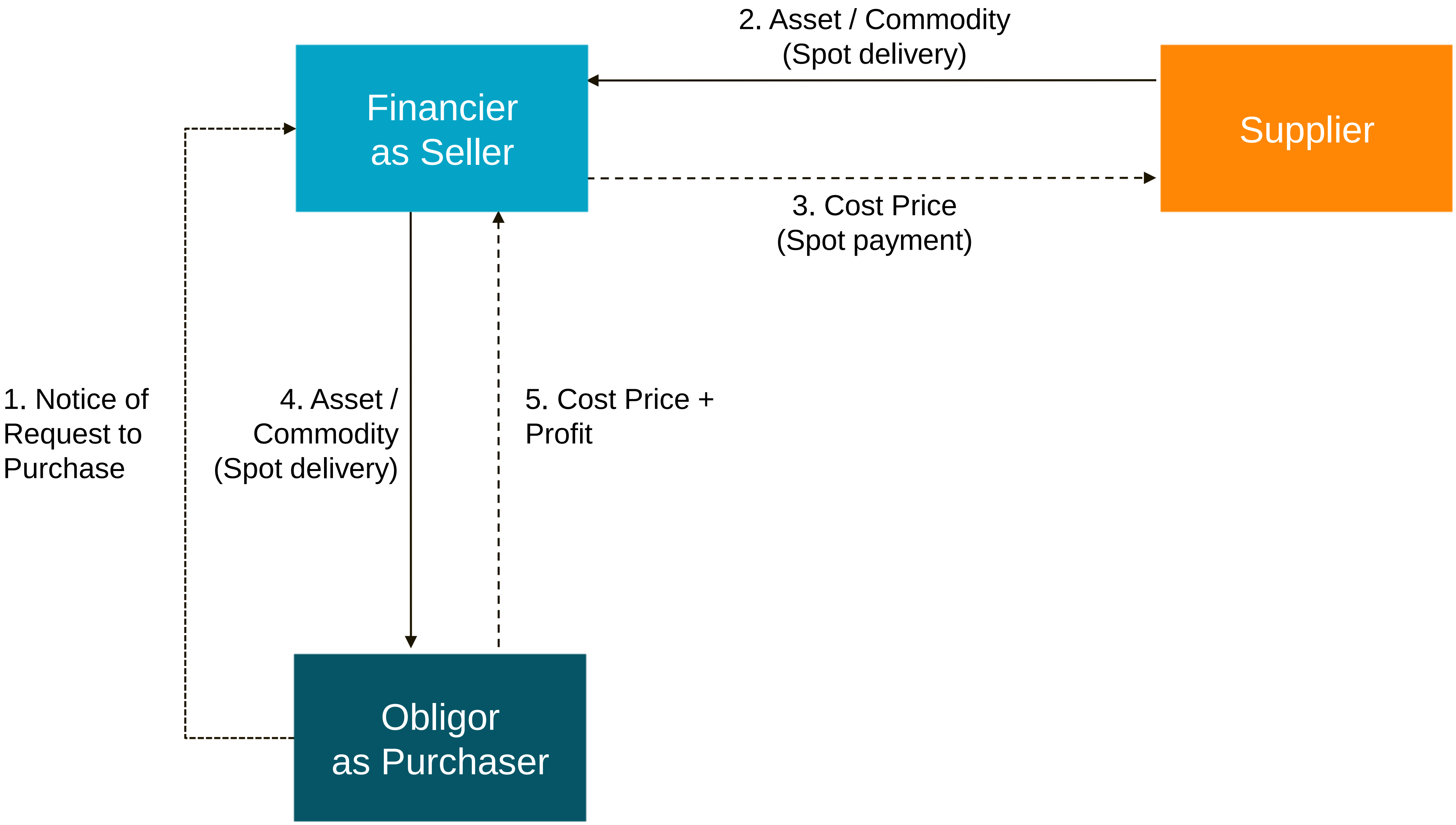
Mudaraba (participation financing)

Murabaha

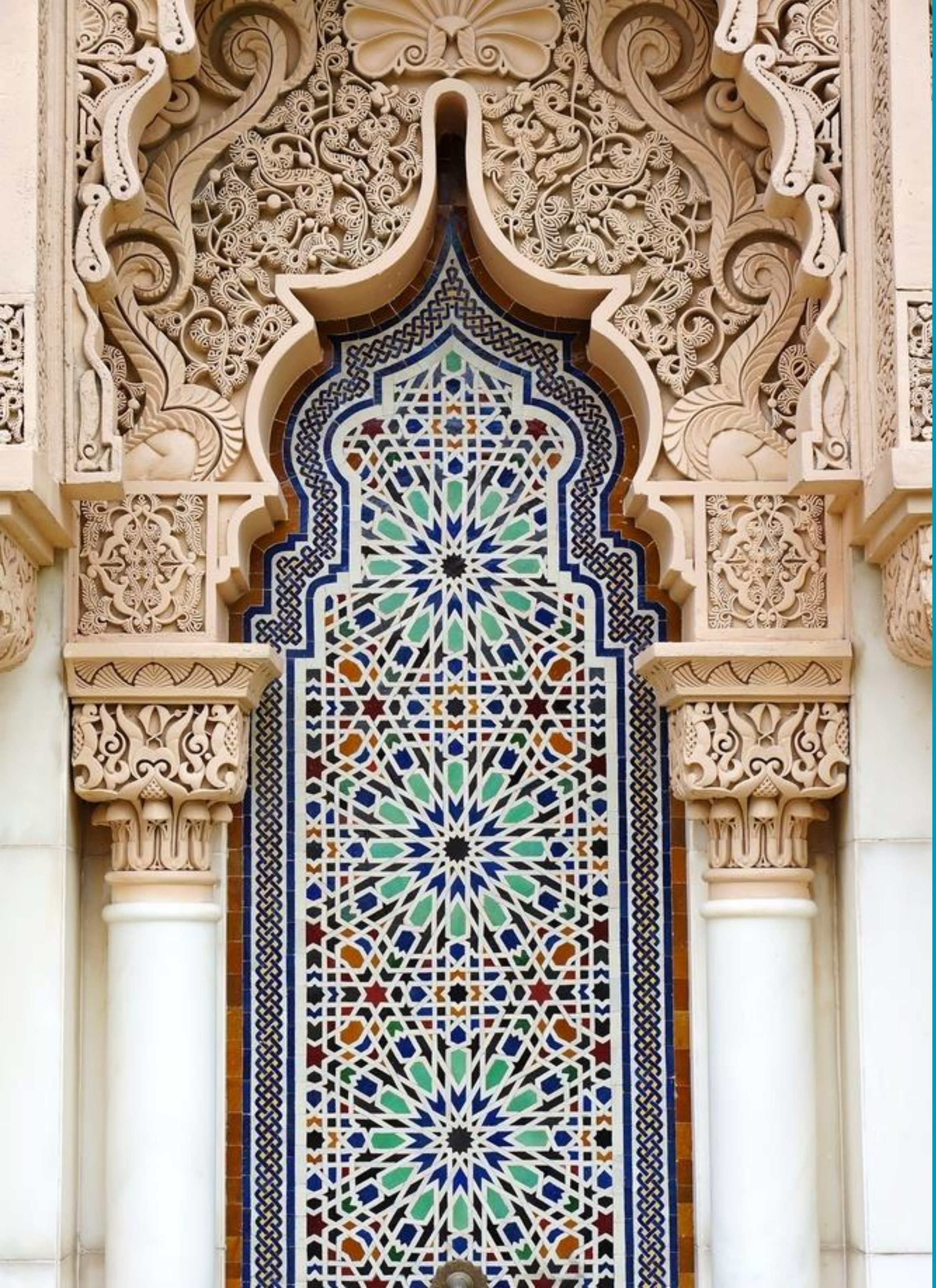
Features

- Financier purchases the goods on behalf of the customer and then on-sells the product to the customer at an agreed price
- Used in trade financing arrangements
- To avoid prohibition on *riba*
  - Profit made by the financier is considered as profit derived from the sale of goods, not interest on monies lent
- Title must pass to the financier
- Agreed price may be an aggregate of:
  - Commodity risk borne by the financier
  - Credit risk of the customer
  - Amount equal to the conventional cost of funds for raising the finance to make the initial purchase

Structure



2. Asset / Commodity (Spot delivery)
Financier as Seller
Supplier
3. Cost Price (Spot payment)
1. Notice of Request to Purchase
4. Asset / Commodity (Spot delivery)
5. Cost Price + Profit
Obligor as Purchaser

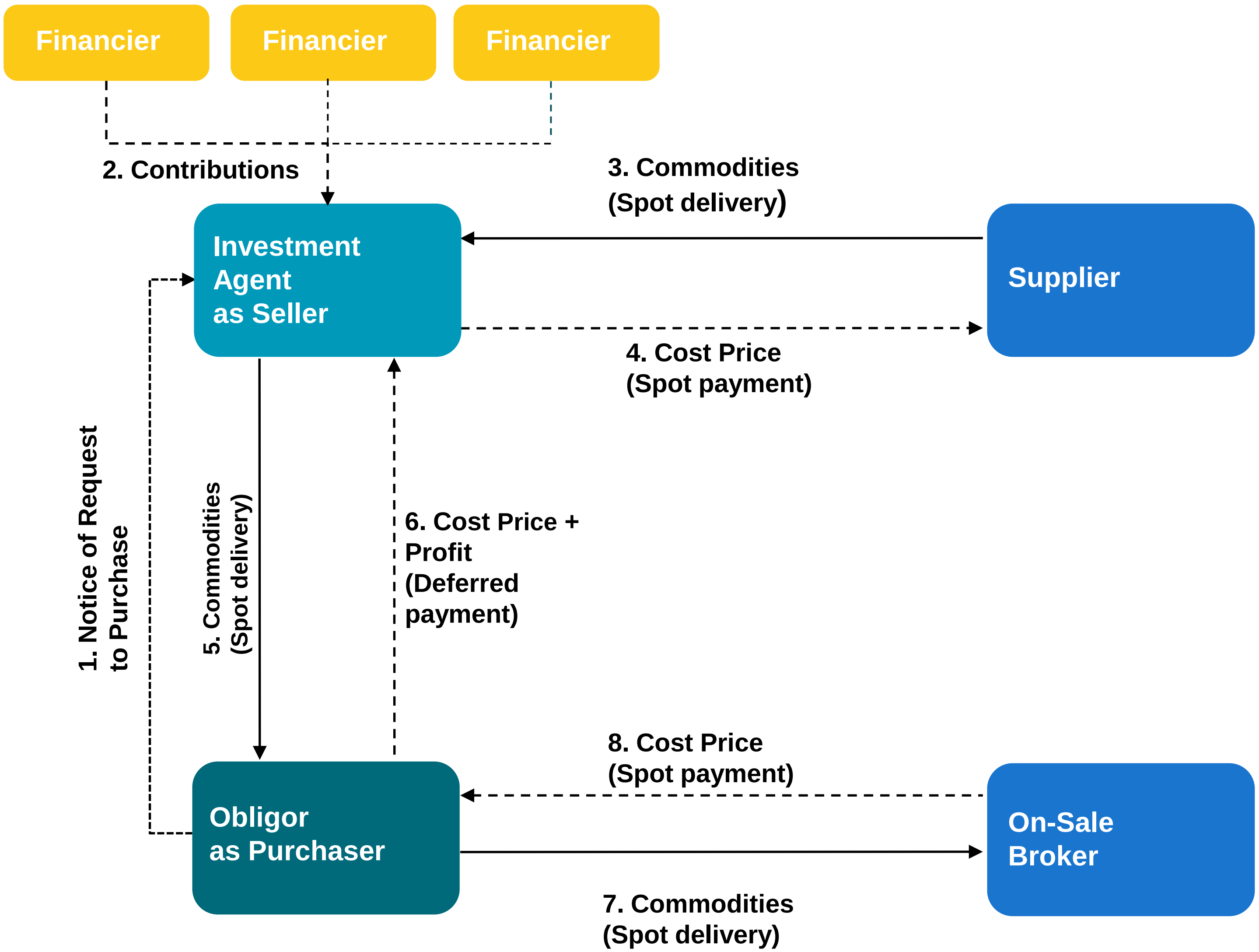


Tarrawuq / Reverse Murabaha

Features

- Financier purchases commodities at market value for spot delivery and spot payment
- Financier immediately on-sells at an agreed mark-up price to the customer for spot delivery and deferred payment
- Customer immediately sells the commodities at market value to a third party for spot delivery and spot payment
- Provide funding for customers who require a cash sum to be advanced to them
- Financier must acquire title to the commodity

Structure

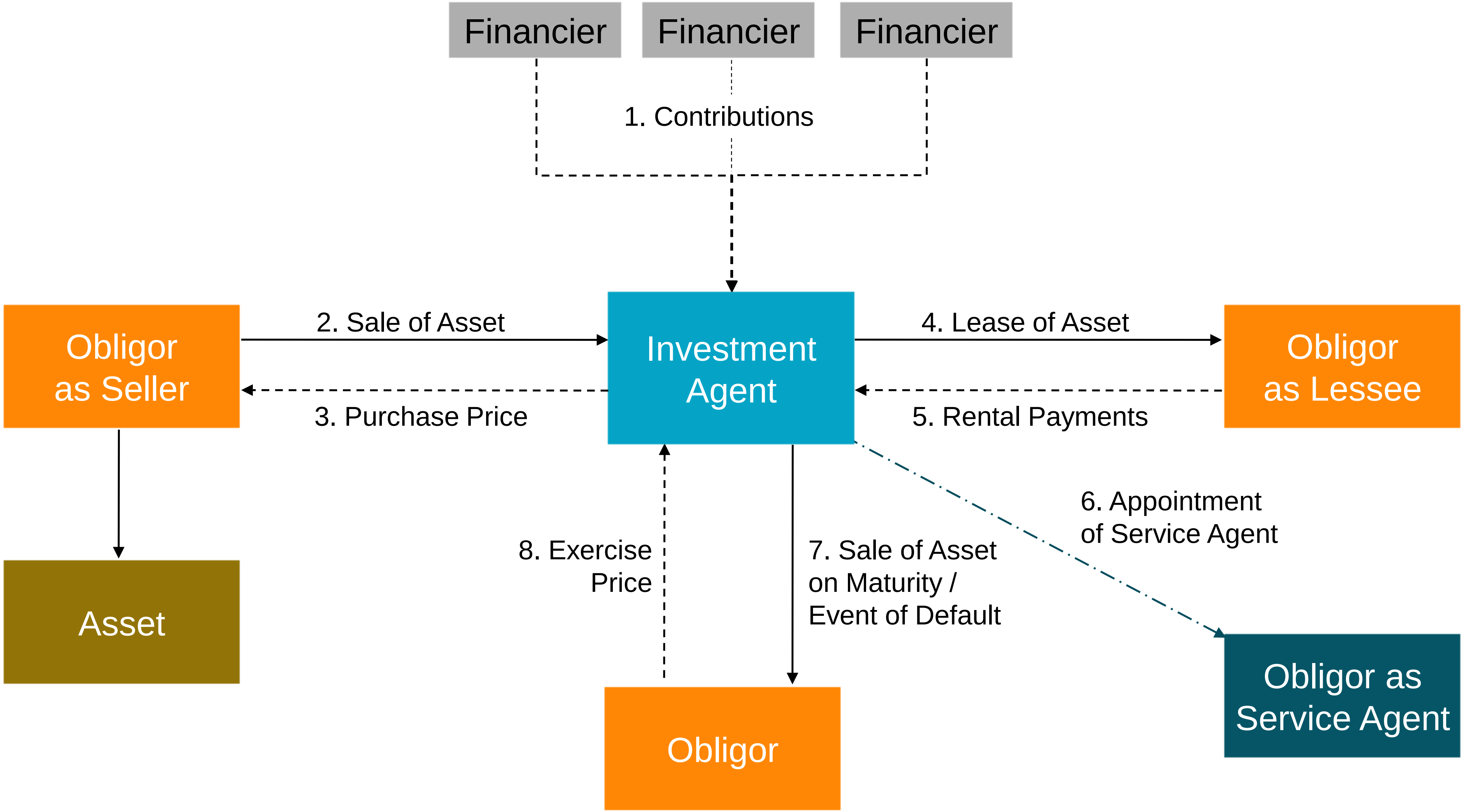

Financier
Financier
Financier
2. Contributions
3. Commodities
(Spot delivery)
Investment
Agent
as Seller
Supplier
4. Cost Price
(Spot payment)
1. Notice of Request
to Purchase
5. Commodities
(Spot delivery)
6. Cost Price +
Profit
(Deferred
payment)
8. Cost Price
(Spot payment)
Obligor
as Purchaser
On-Sale
Broker
7. Commodities
(Spot delivery)

Ijara

Features

- Islamic equivalent of a lease
- Transfer of usufruct (usage and profit) of a particular property by one entity to another entity in exchange for a rental payment
- Leased property is transferred to the lessee on completion of the lease agreement
- Lessee is only responsible for rental payments whilst the use of the asset continues

Structure

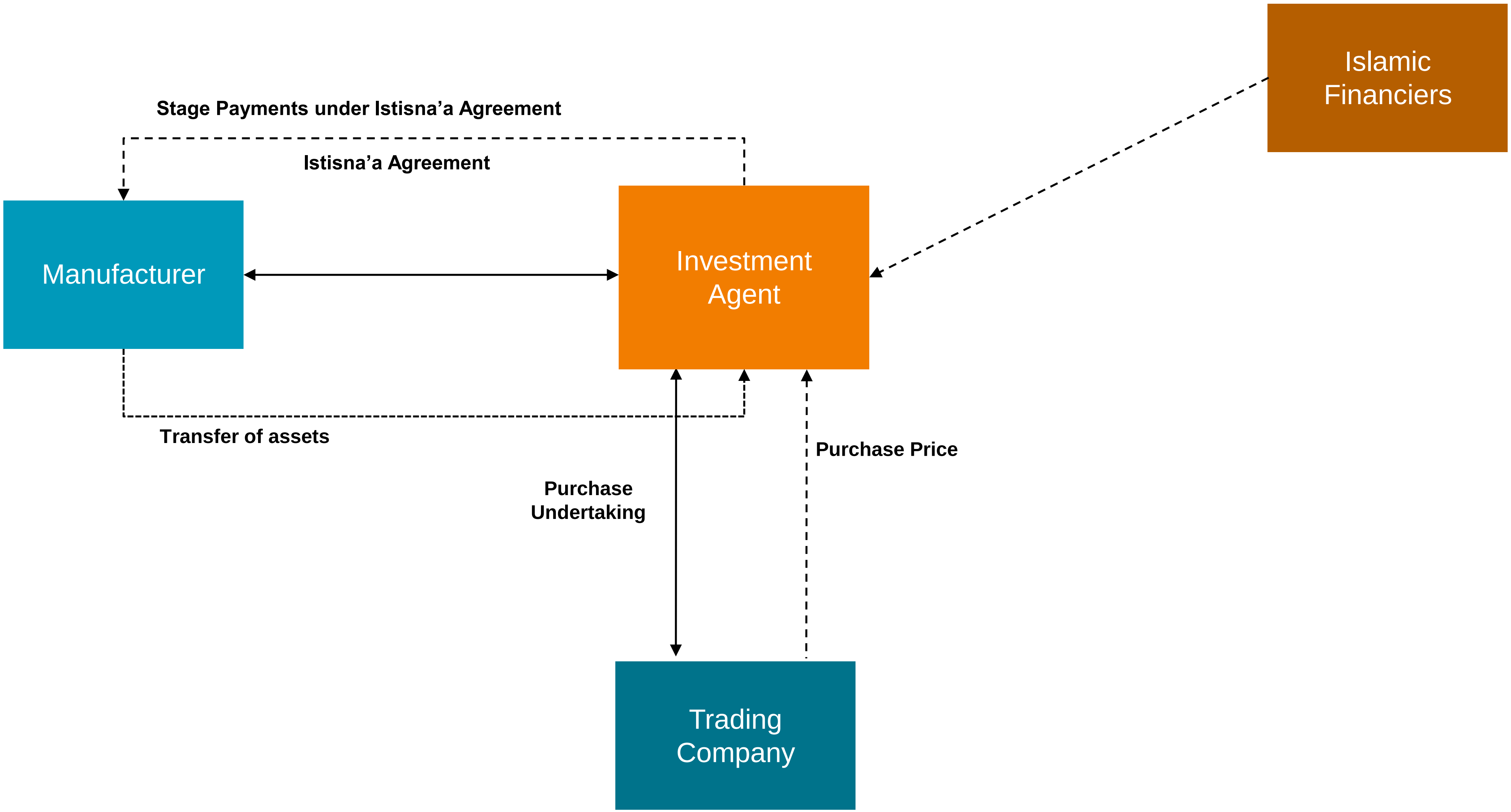

Financier
Financier
Financier
1. Contributions
Obligor
as Seller
2. Sale of Asset
3. Purchase Price
Investment
Agent
4. Lease of Asset
5. Rental Payments
Obligor
as Lessee
Asset
8. Exercise
Price
7. Sale of Asset
on Maturity /
Event of Default
6. Appointment
of Service Agent
Obligor
Obligor as
Service Agent

Istisna'a

Features

- Financier funds the supplier, acquires title to the equipment on completion and immediately passes title to the purchaser on agreed deferred payment terms or leases the asset to the developer (under an *ijara-wa-iktina*)
- Allow for advance funding of major industrial projects or large items
  - E.g. ships and aircraft

Structure



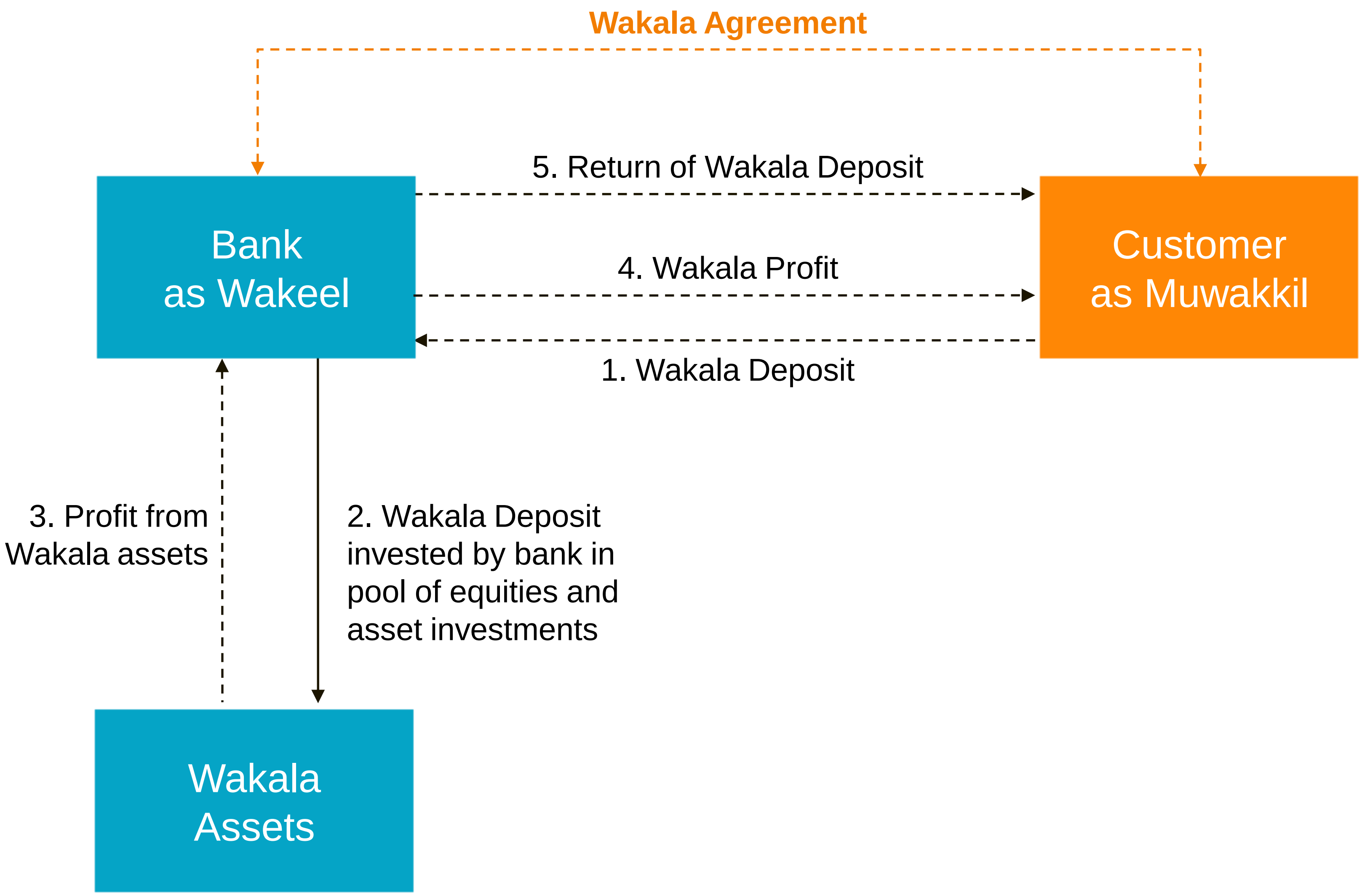
Stage Payments under Istisna'a Agreement
Istisna'a Agreement
Islamic Financiers
Manufacturer
Investment Agent
Transfer of assets
Purchase Price
Purchase Undertaking
Trading Company

Wakala

Features

- Investor (financial institution) agrees to put up capital for a specified period which the agent (entity requiring financing) invests on the investor's behalf in *Sharia'a* compliant investments
- Investor receives a pre-agreed amount of profits and the agent retains any additional profit
- All investments made by the agent must be *Shari'a* compliant
- The agent does not need to be *Shari'a* compliant
- The agent will charge a nominal fee
- Often used in interbank arrangements and between group companies

Structure



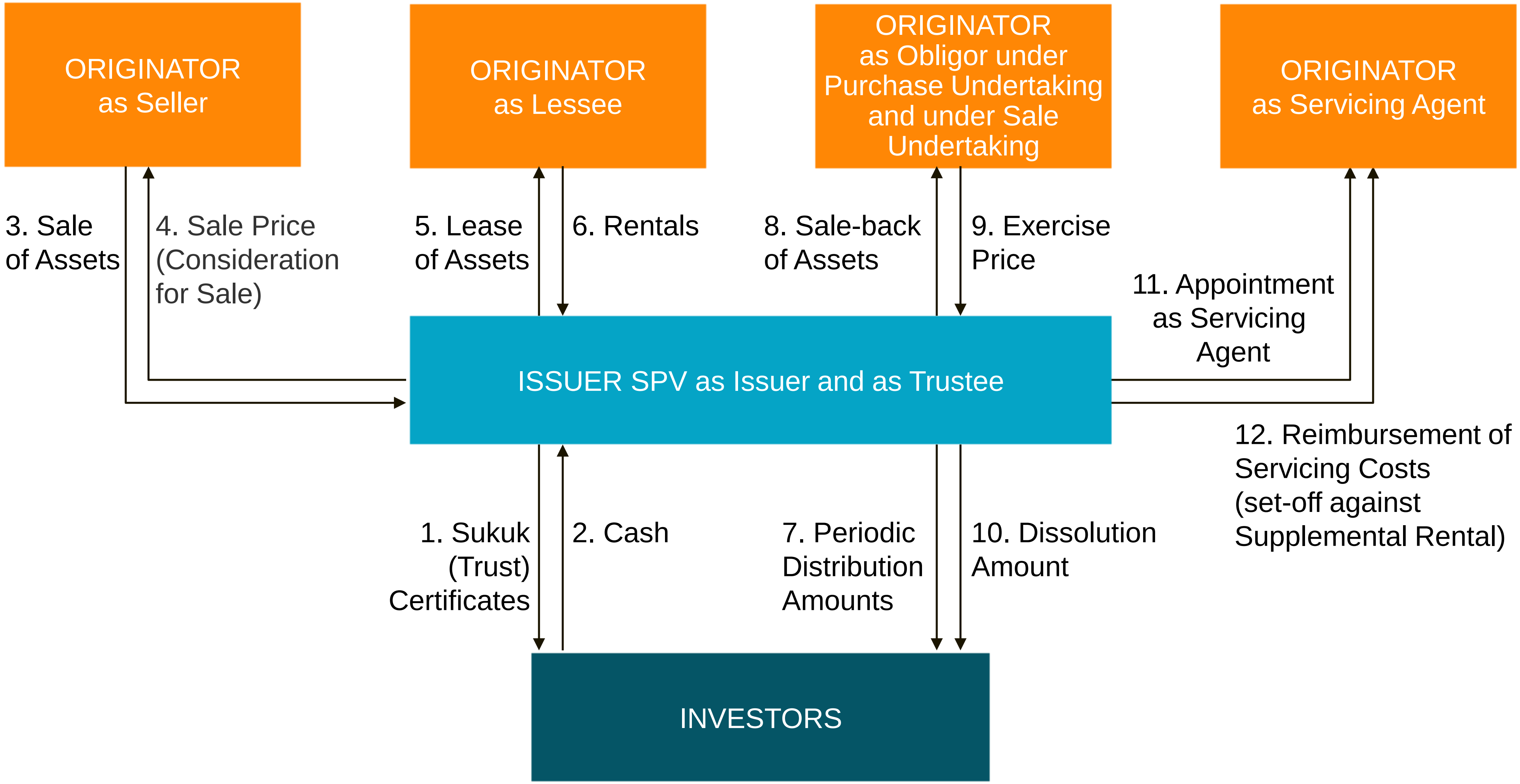
Wakala Agreement
5. Return of Wakala Deposit
Bank
as Wakeel
4. Wakala Profit
Customer
as Muwakkil
1. Wakala Deposit
3. Profit from
Wakala assets
2. Wakala Deposit
invested by bank in
pool of equities and
asset investments
Wakala
Assets

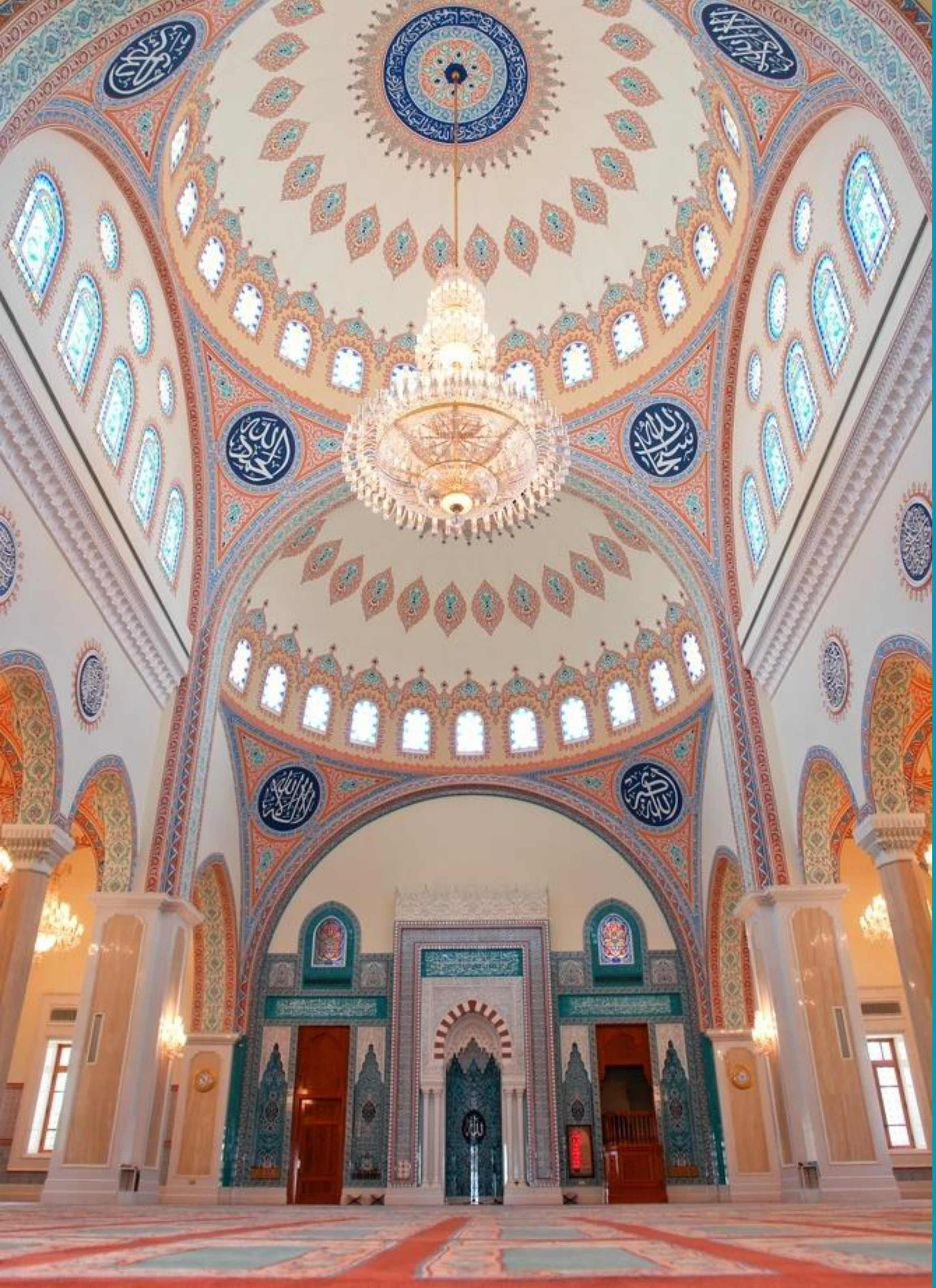
Sukuk

Features

- Trust certificate which represents an undivided beneficial ownership interest in an underlying asset/venture
- Earn returns based on profits from assuming risk related to ownership
- Used in conjunction with other Islamic financing structures
- Structured so that investors do not have recourse to the physical assets and upon default the assets must be sold back to the originator pursuant to the purchase undertaking
- Similarly to corporate bonds, the investor takes credit risk on the originator who is obliged to pay the Sukuk certificateholder irrespective of the performance of the underlying asset
- Assets are not intended to provide security for the transaction, the sukuk being asset-based for *Shari'a* reasons only and most originators having no desire to actually lose the physical asset in question

Structure (Sukuk Al-Ijara)



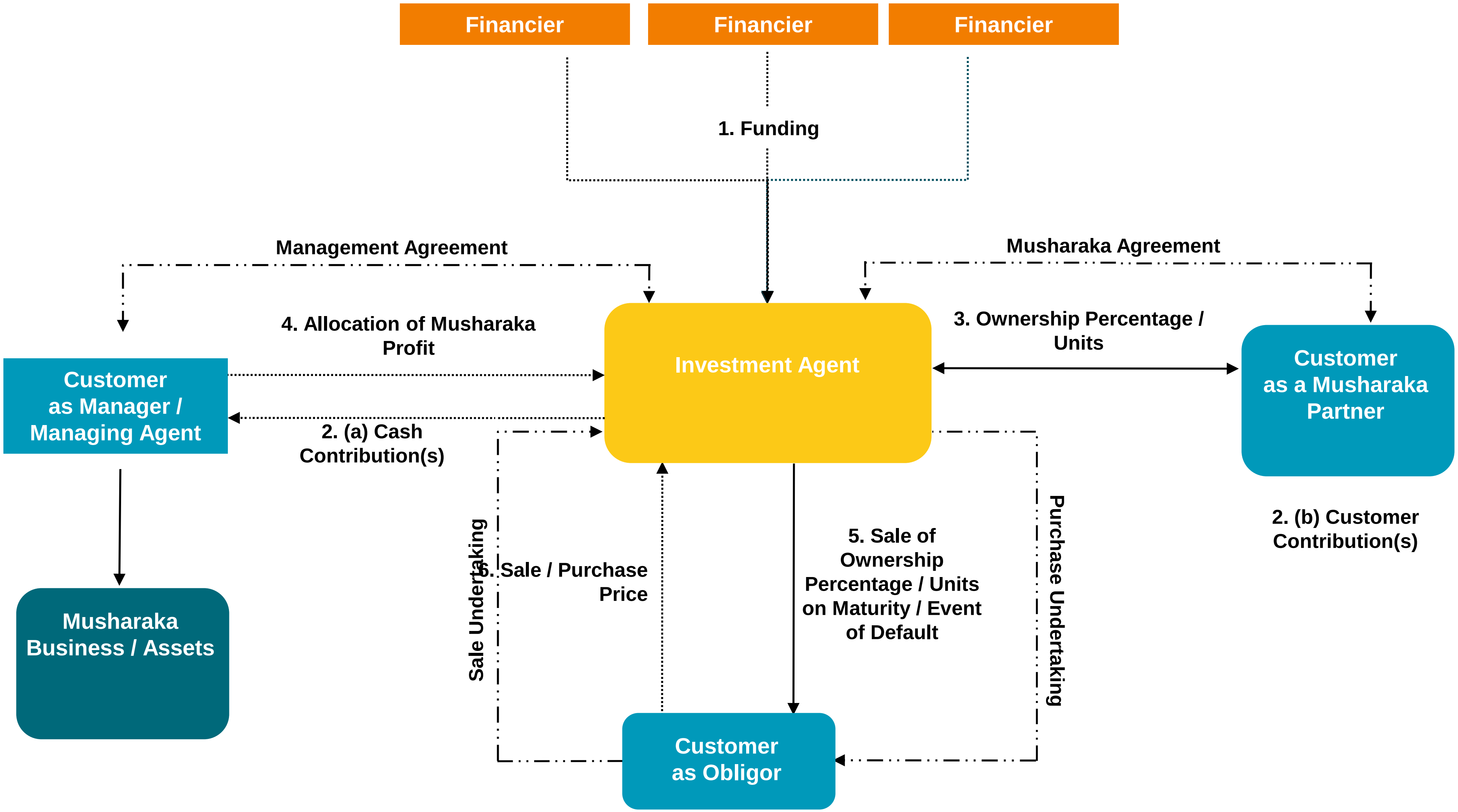


Musharaka

Features

- Financier and investor provide financing for a project in agreed proportions in the form of either cash contributions or contributions in kind
- Financier and investor share equally in the profit and loss of the project in proportion to their initial investment
- Similar to a partnership or joint venture
- Used in long-term investment projects

Structure



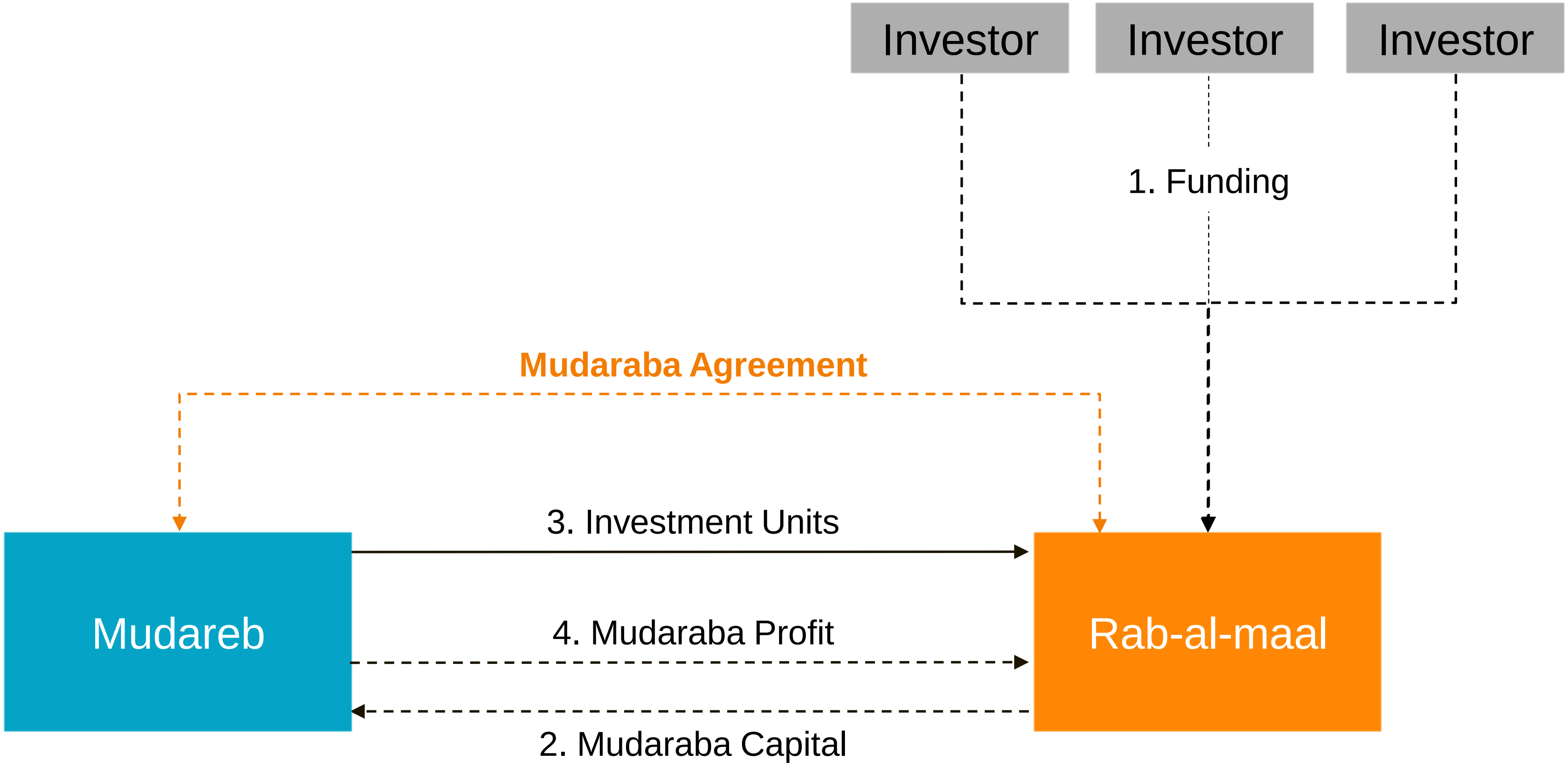
Financier
Financier
Financier
1. Funding
Management Agreement
Musharaka Agreement
4. Allocation of Musharaka Profit
Investment Agent
3. Ownership Percentage / Units
Customer as Manager / Managing Agent
Customer as a Musharaka Partner
2. (a) Cash Contribution(s)
Sale Undertaking
6. Sale / Purchase Price
5. Sale of Ownership Percentage / Units on Maturity / Event of Default
Purchase Undertaking
2. (b) Customer Contribution(s)
Musharaka Business / Assets
Customer as Obligor

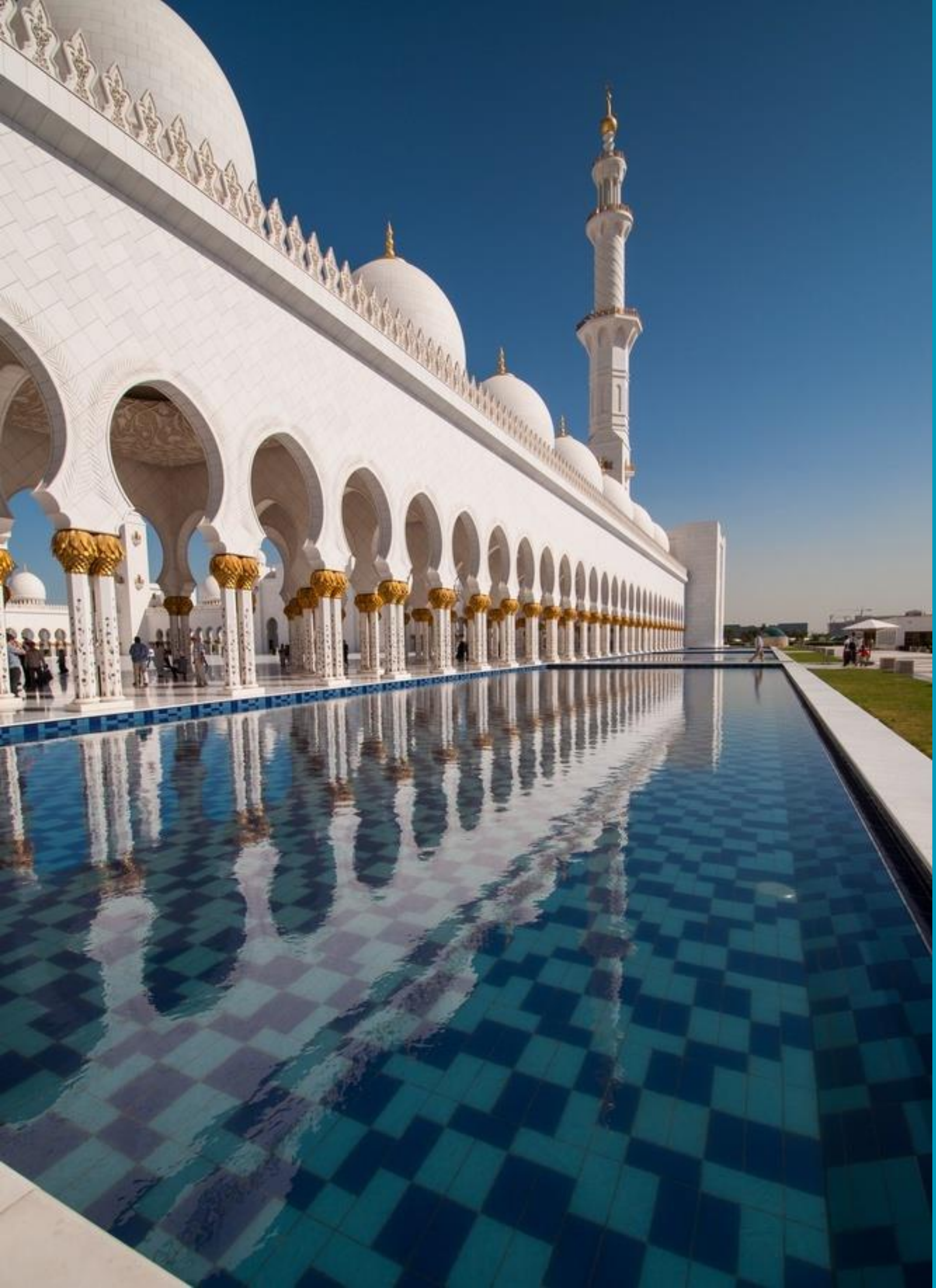
Mudaraba

Features

- Contractual arrangement between a group of investors (rab al maal) and a manager (mudarib)
- Investors put up capital which the mudarib invests
- Flexible arrangement which can be used in a number of ways
  - Akin to a funded participation arrangement in conventional financing where the investors are similar to the participants who provide funds to the grantor (mudarib) who in turn has a direct relationship with the investor
  - For the establishment of investment funds with the fund manager acting as mudarib and investors subscribing to the mudaraba fund
- Mudarib can be any entity but the mudarib's investments must be *Shari'a* compliant
- Mudarib will charge a fee for providing its expertise which will customarily be a proportion of the profits generated from the investments

Structure


Investor
Investor
Investor
1. Funding
Mudaraba Agreement
3. Investment Units
Mudareb
4. Mudaraba Profit
Rab-al-maal
2. Mudaraba Capital



Legal and practical issues

Risks and liabilities

- Contracts and techniques used in Islamic financing may give rise to additional risks and liabilities for the financier or the transaction
- However, many of these arise in conventional financing structures and are not unique to Islamic financing

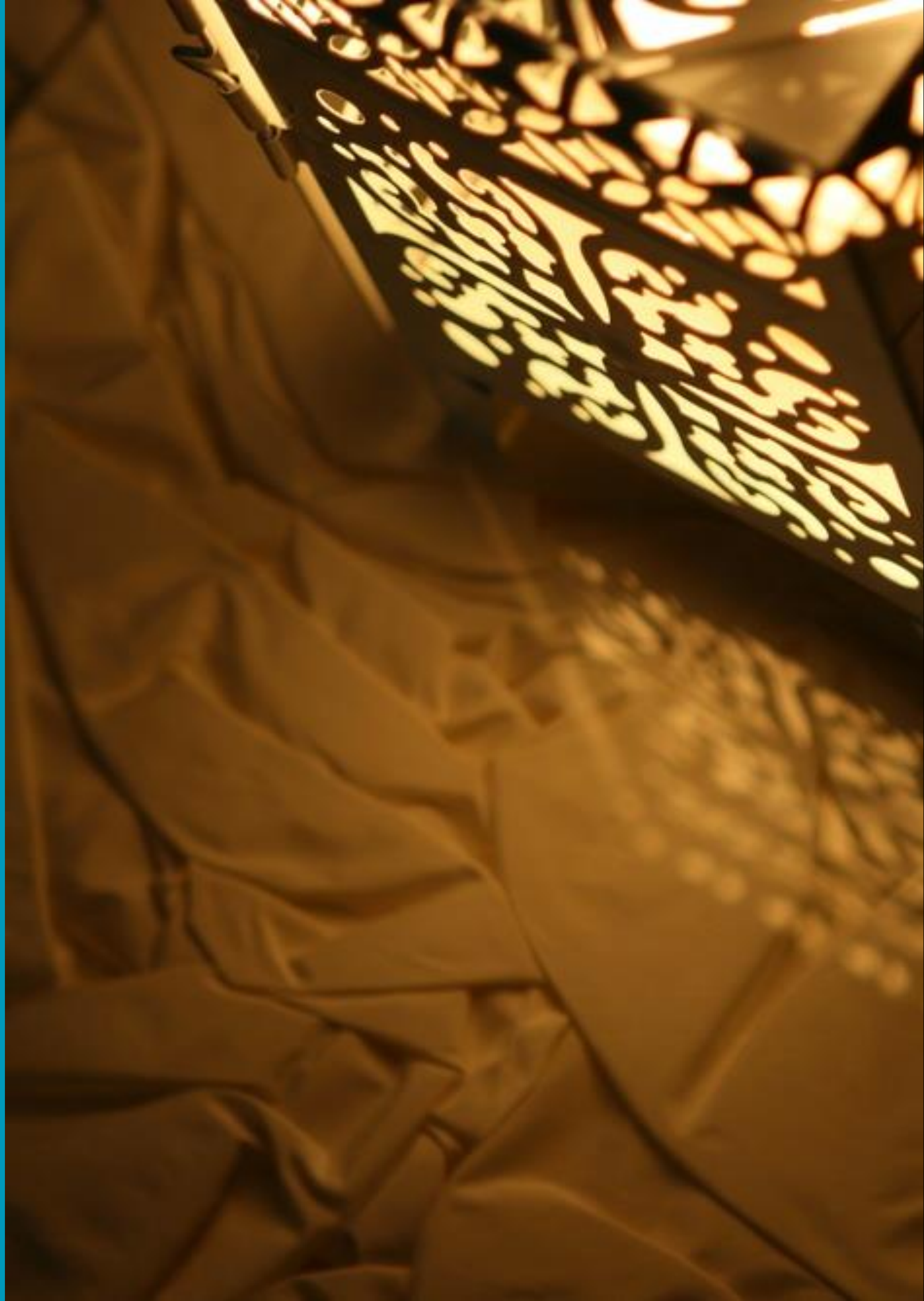
Risks and liabilities – examples

- Ownership liability may be incurred if the financier owns an asset for a period before transferring it to the end-user, such as liability for death or injury or environmental damage. If the financier seeks insurance to protect itself, the insurance should take the form of Islamic insurance (takaful)
- Tax liability e.g. do taxes arise on the acquisition or on-sale of an asset? What are the income and capital gains tax consequences for a financier? How can the transaction be made tax neutral?
- Warranties e.g. is the financier, as owner or seller of an asset, making any warranty (e.g. as to its title to the asset or the condition or usability of the asset) which it would want to disclaim?
- Interposing a third party between a supplier and an end-user may give rise to issues e.g. can the end-user receive the benefit of a supplier's warranties?
- Loss or destruction or delays in the production or construction of the asset may be an issue for the Islamic financier
  - if there is no 'deliverable' asset, can it claim any payments from the end-user? In other words, can it pass on the asset risk to its customer?

Co-financings

- An increasing number of financings are co-financings, particularly in project finance, where an Islamic finance tranche is used in conjunction with conventional financing
- As in any multi sourced financing, the parties will want to agree how the two financings will operate together and what rights each group of financiers will have
  - A mechanism to establish the amount of the 'investment' in the project by each financier (which will comparison of loans with, for example, purchase or lease payments)
  - The agreed 'investment' amount can then be used as a benchmark in relation to a number of issues such as agreeing scheduled payments, voting rights and allocation of funds if there is a payment shortfall on acceleration and termination of the financings
  - How to exercise remedies on default such as the right to sell project assets, how proceeds of sale will be used and how proceeds of insurance will be applied
  - Islamic financiers and conventional financiers may in theory have very different rights (e.g. as owner or lessor in possession in the case of an Islamic financier, or as secured party in the case of a conventional lender), but parties would expect assets to be available for the benefit of all the financiers

Part 3
CODIFICATION



Overview

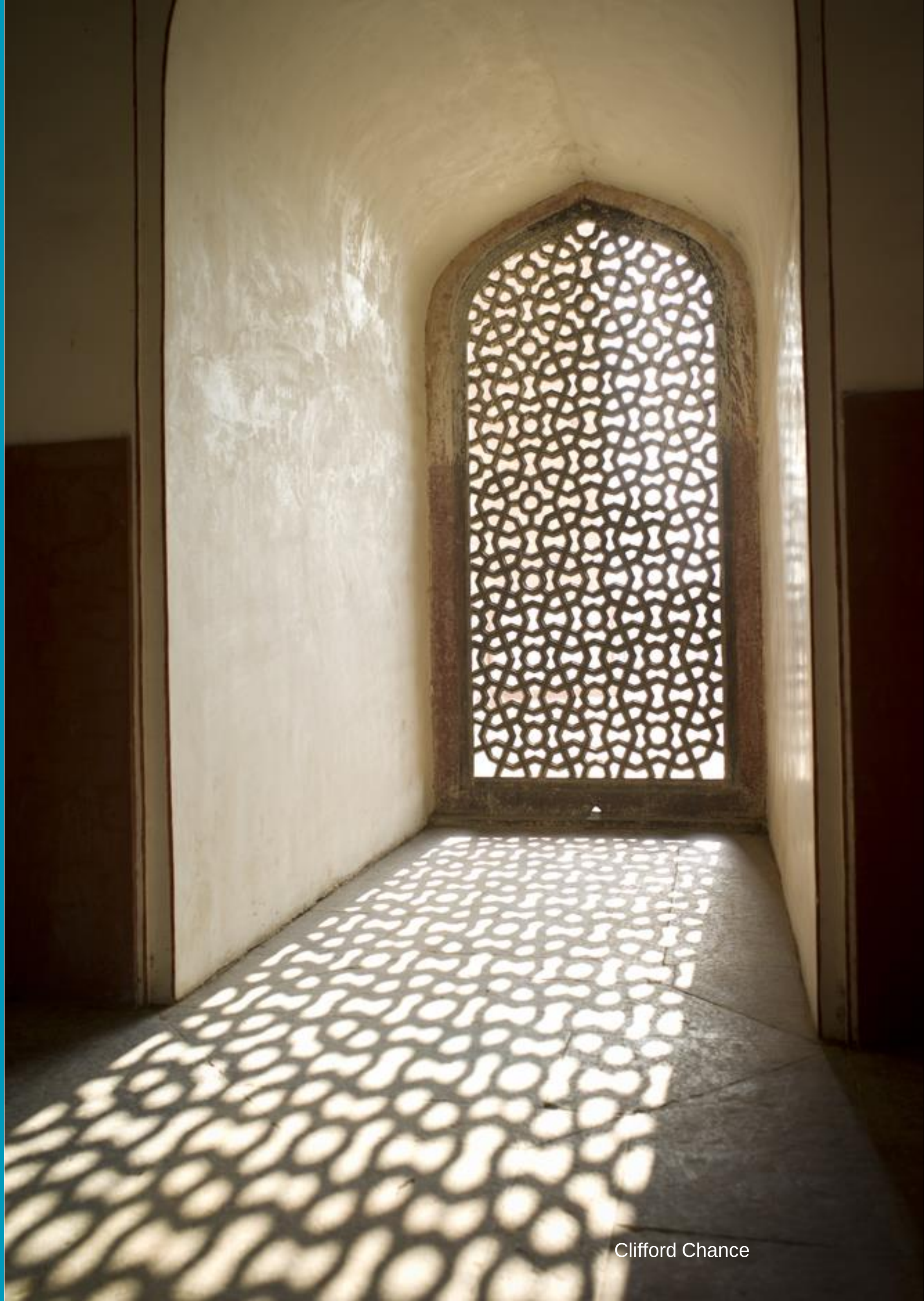
Overview

- More relaxed regulatory regime than conventional finance
- Regulated on a country-by-country basis
  - Role of financial regulator?
  - Role of Islamic scholars?
- Standards and guidelines set by international institutions
  - May influence national regulatory framework
  - No means of enforcement

Challenges

- Compliance with *Shari'a* principles
  - Subject to differing interpretation by Islamic scholars
  - Different traditions and structures
  - Ambiguity and lack of consistency
  - Focus on how to achieve compliance rather than what is compliance
- How closely should regulation of Islamic finance parallel regulation of conventional finance?
- Increasing cross-border transactions

Standard-setting institutions



Standard-setting institutions

- Three main bodies

- Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)
  - Based in Bahrain
  - Formed in 1990

- International Islamic Financial Market (IIFM)
  - Based in Bahrain
  - Formed in 2002

- Islamic Financial Services Board (IFSB)
  - Based in Kuala Lumpur
  - Formed in 2002

Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI**)

- Prepares accounting, auditing, governance, ethics and *Shari'a* standards
- Standards set by its *Shari'a* Board
  - Made up of scholars representing *Shari'a* supervisory boards of Islamic financial institutions and central banks
- Total of 95 standards issued: (a) 54 on Shari'a, (b) 27 accounting, (c) 5 auditing standards, (d) 7 governance, (and e) 2 codes of ethics
- New standards are being developed and existing standards reviewed
- AAOIFI standards are followed – as part of regulatory requirement or institutions' internal guidelines – in many jurisdictions
- Consequently, AAOIFI standards have introduced greater harmonisation of Islamic finance practices across the world
  - Standards have been adopted in Bahrain, DIFC, Jordan, Lebanon, Qatar, Sudan and Syria and influenced regulators in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia and South Africa

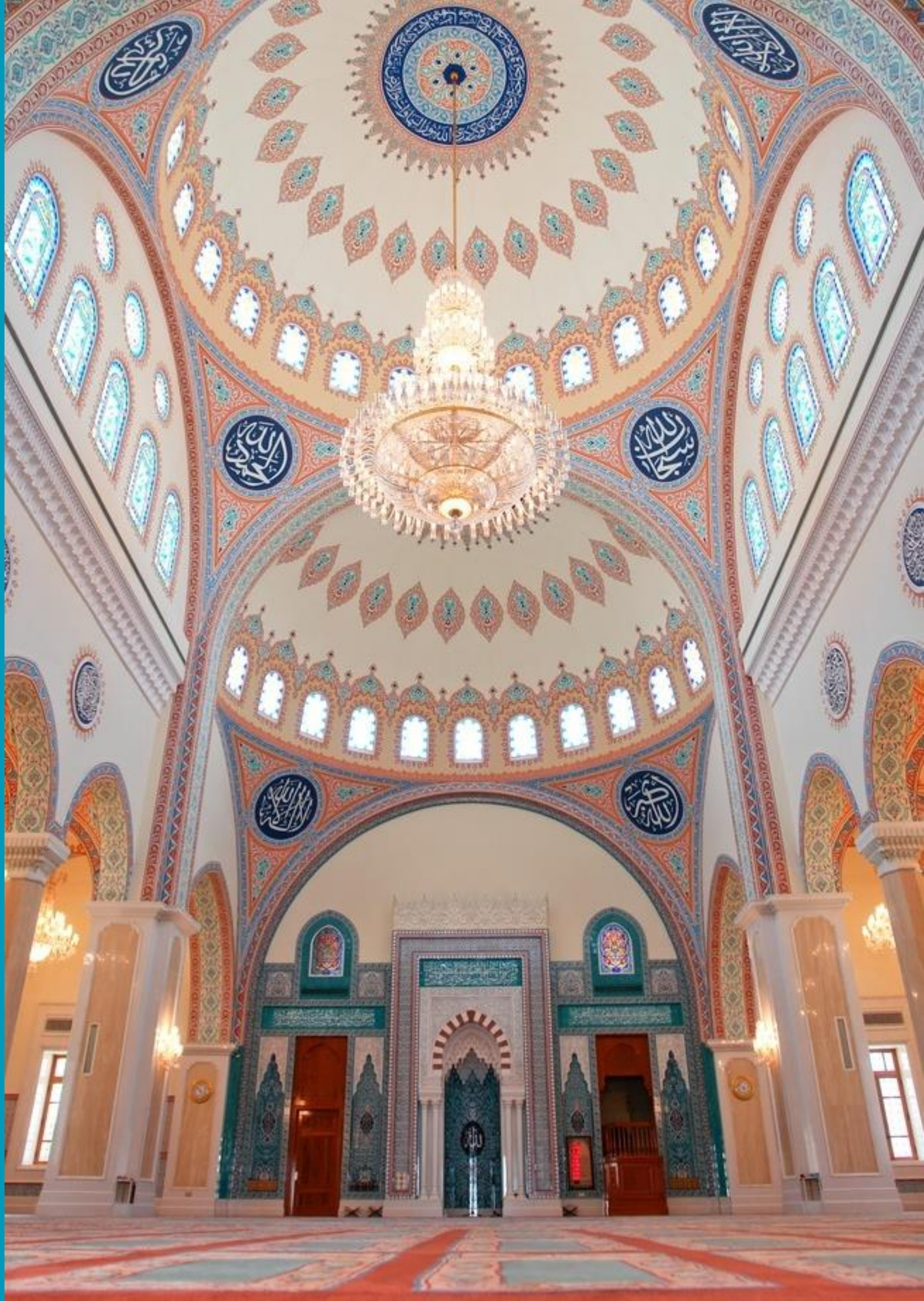
International Islamic Financial Market (**IIFM**)

- IIFM is the international Islamic financial services industry’s standard setting organization focused on the Islamic capital and money market segments of the industry
- Primary focus lies in the standardization of Islamic financial products, documentation and related processes at the global level
- IIFM was founded with the collective efforts of the Central Bank of Bahrain, Islamic Development Bank, Autoriti Monetari (i.e. Monetary Authority) Brunei Darussalam, Bank Indonesia, Central Bank of Sudan and the Bank Negara Malaysia (delegated to Labuan Financial Services Authority) as a neutral and non-profit organization
- In addition to the founding members, IIFM is supported by other jurisdictional members such as State Bank of Pakistan, Dubai International Financial Centre, Indonesian Financial Services Authority as well as a number of regional and international financial institutions and other market participants

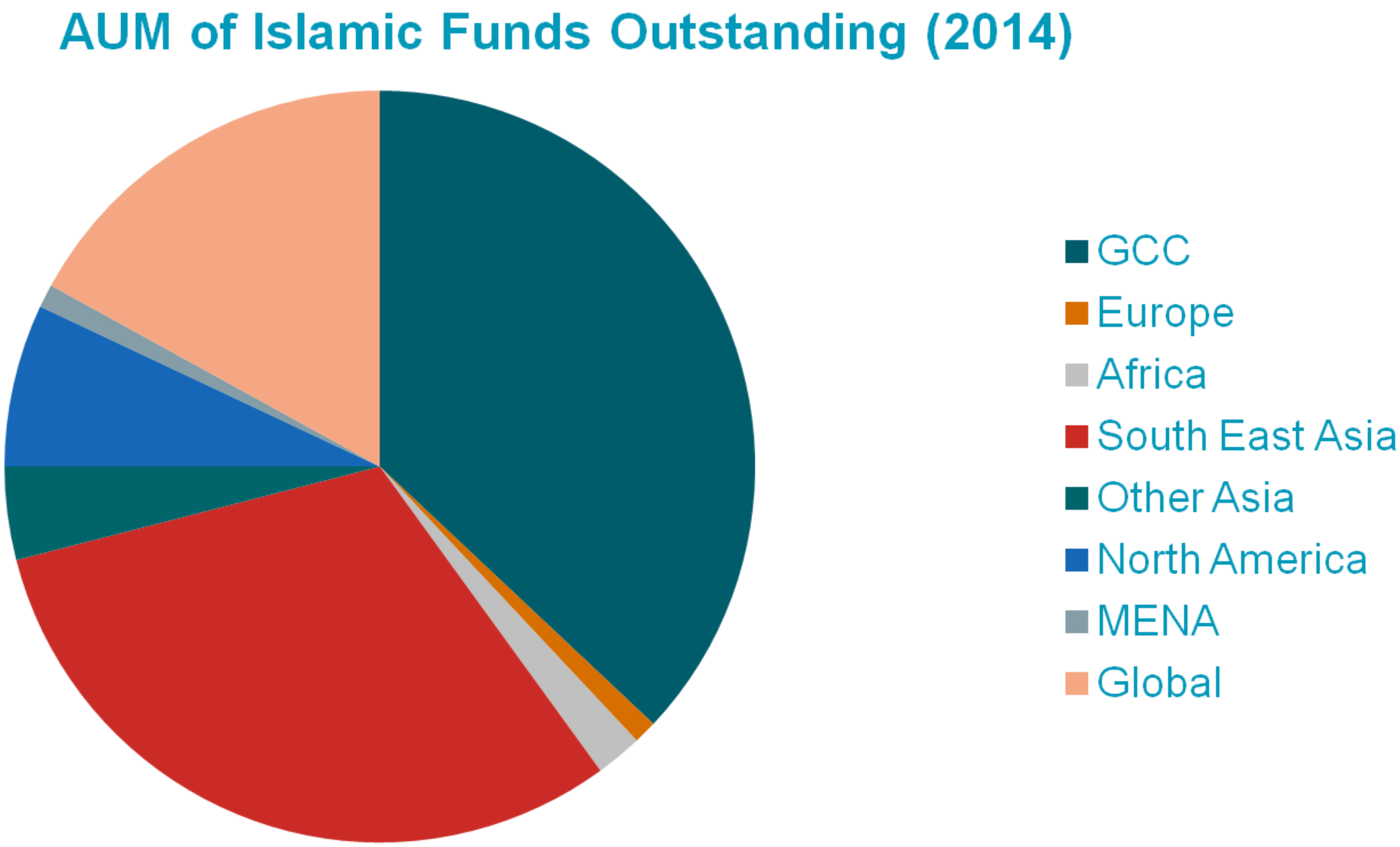
Islamic Financial Services Board (**IFSB**)

- IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry
  - Broadly defined to include banking, capital markets and insurance sectors
- The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders
- The 189 members of the IFSB comprise 65 regulatory and supervisory authorities, 8 international inter-governmental organisations, and 116 market players (financial institutions, professional firms and industry associations) operating in 47 jurisdictions.

Part 4
FUNDS



Islamic funds industry – overview



Fund formation – structure and documents

- Traditional private equity/venture capital funds are inherently *Shari'a*-compliant, hedge funds are not
  - Investments in equity
  - Risk sharing between investors and management
- Management fee
  - Based on *wakala* (or agency arrangement) – fee is fixed amount or percentage of capital commitments
- Carried interest or performance fee
  - Based on *mudaraba* (or limited partnership) – one party provides capital and the other party provides expertise and management in return for share of profit
- Basic documentation for *Shari'a*-compliant fund similar to conventional fund

Fund formation – terms

- Certain terms need to be revisited
  - Equalisation mechanism – *murabaha* arrangement (or cost plus profit)
  - Interest on amounts due by defaulting Limited Partners – donate to Islamic charity
- Typically structured as standard limited partnership in Cayman Islands
  - Avoid corporate vehicles – multiple share classes not *Shari'a*-compliant
- Unit trust structure
  - Quite common with Middle East-sponsored funds domiciled in Bahrain
- Frequently established as parallel fund to conventional fund
  - Does not restrict operations of conventional fund or burden its investors with additional cost
  - Alternative approaches include feeder fund or conventional fund with excuse/opt-out mechanisms

Fund operation – investment restrictions

- Investment policy must contain restrictions on investments in industries considered *haram* (or against religion)
- May purify any *haram* earnings by separating them from legitimate profits and donating them to an approved charity
- Prohibit investments in:
  - conventional financial services (including conventional banks and insurance companies)
  - gambling and casinos
  - alcohol or pork products
  - certain entertainment, such as gossip columns or pornography (but often including cinemas, music, publications)
  - weapons or military equipment
  - any other immoral or unethical activities
- Application subject to differing interpretations (e.g., investment in hotel or restaurant that serves alcohol)

Fund operation – investment restrictions
(continued)

- May not obtain or provide conventional loans or otherwise invest in conventional interest bearing instruments
  - Includes convertible debt securities
- Cash may only be invested in Shari'a-compliant short-term investment products
- Investments in preferred shares or fixed income securities are also restricted
- Financial parameters
  - Ratio of total conventional debt to total assets should be less than 33%
  - Ratio of interest income (plus income from any incidental haraam or unidentifiable activities) to total revenue should be less than 5%
  - Ratio of liquid assets (cash plus accounts receivable) to total assets should be less than 45%
- Any conventional debt of portfolio company must be restructured in Shari'a-compliant manner generally within three years after acquisition

Fund operation – supervisory board

- Must appoint *Shari'a* supervisory board or consultant for each fund
  - Usually engage already existing *Shari'a* board of sponsor or anchor investor
  - Alternatively, hire *Shari'a* consultant or invite members for fund’s own *Shari'a* supervisory board
  - Certain service providers provide *Shari'a* supervisory boards on a contractual basis
- Required to review and approve private placement memorandum and other fund documents
- Routinely review fund activities and produce report regarding ongoing *Shari’a* compliance (often annually)
  - May involve visiting portfolio companies and examining investment documentation
- Supervisory board approval for each investment or only those that fall outside agreed set of guidelines
- Supervisory board may require fund to dispose of investments, deleverage capital structure of a portfolio company and/or substitute Islamic financing instruments for conventional financing

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